Supreme Court, U. S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

No. 79-1876

DAVID R. BLAKE and BETTY H. BLAKE,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS SIXTH CIRCUIT

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Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS SIXTH CIRCUIT

The Petitioners, David R. Blake and Betty H. Blake, respectfully pray that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered in this proceeding on February 25, 1980.

OPINIONS BELOW

The Opinion of the United States Tax Court, dated October 6, 1976, is reported at 67 TC 7 (1976) and is appended hereto as Appendix A.

The Decision of the United States Tax Court, dated April 21, 1977, is appended hereto as Appendix B.

The opinion of the United States Court of Appeals, Sixth Circuit, dated February 25, 1980, is not yet officially reported and is appended hereto as Appendix C.

The Judgement and Mandate of the United States Court of Appeals, Sixth Circuit, dated February 25, 1980, is appended hereto as Appendix D.

JURISDICTION

The judgment of the Court of Appeals was entered February 25, 1980. Jurisdiction of this Court is invoked under 28 U.S.C. Sect. 1254 (1).

QUESTIONS PRESENTED FOR REVIEW

1. Did the United States Court of Appeals, Six Circuit, extend the statute, Section 1235 of the Revenue Code of 1954, in ruling that a two-part transfer of rights in a patent did not qualify for capital gain treatment even when it was admitted that all substantial rights were indeed transferred?
2. Is Treasury Regulation 1.1235-2 of the 1954 Code ambigious in its statement, "(1) The term 'all substantial rights to a patent' means all rights (whether or not then

held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred?"

3. Is Treasury Regulation 1.1235-2 of the 1954 Code unreasonable in restricting against a dual licensing of two different industries when all substantial rights were admittedly transferred?
4. Can accrual taxpayer report royalty income in 1968, the year when the infringer's petition for a writ of certiorari in the patent litigation action was denied by the United States Supreme Court, while a petition for a rehearing was pending?
5. If this Court rules that a two part transfer can qualify for capital gain treatment (Question 1, above) should the Court of Appeals review the income received by petitioners from the Level Corporation?

STATUTES AND TREASURY REGULATIONS INVOLVED

SALE OR EXCHANGE OF PATENTS
Section 1235 (a) of the Internal Revenue Code of 1954.

(a) General - A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are -

(1) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(2) contingent on the productivity, use, or disposition of the property transferred.

Treasury Regulation, Section 1.1235-2

(b)(1) The term "all substantial rights to a patent" means all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The term "all substantial rights to a patent" does not include a grant of rights to a patent -

(i) which is limited geographically within the country of issuance

(ii) Which is limited in duration by the terms of the agreement to a period less than the remaining life of the patent;

(iii) Which grants rights to the grantee, in fields of use witin trades or industries, which are less than all the rights

covered by the patent, which exist and have value at the time of the grant; or

(iv) Which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.

The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction.

ACCRUALS

Section 461(a) of the Internal Revenue Code of 1954, 26 U.S.C.

"The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income."

Treasury Regulation Section 1.461-1(a)(2) (In Part)

"Under an accrual method of accounting, an expense is deductible for the taxable year in which all of the events have occured which determine the fact of liability and the amount thereof can be determined with reasonable accuracy.

"While no accrual shall be made in any case in which all of the events have not occured which fix the liability, the fact that the exact amount of the liability which has been incurred cannot be determined will not prevent the accrual within the taxable year or such part thereof as can be computed with reasonable accuracy."

STATEMENT OF THE CASE

Petitioners are David R. Blake and Betty H. Blake, husband and wife, who consistently filed joint income tax returns on an accrual basis. An audit of those returns for 1968, 1969 and 1970 resulted in an alleged deficiency of $1,447.20 for 1969 and $26,177.38 for 1970. The deficiency arose from the petitioner reporting certain royalty income on a capital gain basis and also accruing as income in 1968 a portion of the royalties allowed by a district court for patent infringement, while the Commissioner disallowed both the capital gain treatment and the accrual of income in 1968.

In 1947 petitioner filed for a patent for a glide which fastened to the bottom of furniture legs and stopped annoying furniture wobble. In 1949 the petitioner licensed L & B Products, a leading manufacturer of restaurant tables, in all fields, in all areas and for the life of the hoped-for patent on which the application was then still pending.

With the passage of years without an issuance of the patent, and after a competitor, the Level Corporation (later affiliated with and succeeded by the United Industrial Syndicate—not to be confused with the Ever Level Glide, Corp.) began to make the glide because there was no patent protection, L & B Products terminated the agreement.

Then, in 1954, still prior to the issuance of any patent, the petitioner licensed the American Seating Company, a leading manufacturer of school furniture, for the public seating field, excluding the restaurant and cafeteria fields. The patent was issued in 1957. Petitioner then relicensed Ever-Level Glides, now a subsidiary of L & B Products, in 1960 for all fields except that portion under the American Seating License. Through non-use, part of the field granted

to Ever Level Glides was later abandoned, but the Commissioner, the Tax Court and the Court of Appeals all concurred that all rights of substantial value had been transferred by the two licenses.

In 1960 the petitioner commenced action against an infringer, the Stewart-Warner Corporation. That action in the Federal District Court resulted in a decision of infringement in favor of the petitioner in 1967. The defendant in the infringement suit moved for an order limiting the issues in the accounting solely to a determination of the damages sustained by the patent holder, the petitioner herein, but the District Judge denied the motion, finding that the co-plaintiff, Ever Level Glides, was entitled to a recovery of profits lost to the infringer. Subsequently Ever Level Glides assigned to petitioner here, as additional royalties, any lost profits it might be awarded in return for petitioner assuming all legal expenses incurred and being incurred by Ever Level Glides in the patent litigation and the proceedings before the Special Master.

In 1967 the infringer appealed the patent decision to the Court of Appeals, Seventh Circuit, which affirmed the decision in 1968. The infringer then filed a petition for a writ of certiorari to the United States Supreme Court, which petition was denied on October 14, 1968. Because the patented device contained silicone putty, the case was known as "The Silly Putty Case" when denial of the petition for a writ of certiorari was made.

In December, 1968, the Stewart-Warner Corporation set up a reserve of $43,304 to pay the patent holder, David R. Blake, those royalties directly due him, but made no effort to set up a reserve for any amount which the Special Master might find due under the accounting for lost profits due Ever Level Glides. Petitioners herein accrued the $43,304 income on their 1968 tax.

During 1969 petitioner also received, under settlement agreements, infringement damages of $5,527.90 from Robert E. Miller and $5,000.00 from United Industrial Syndicate, a successor-affiliate of the Level Corporation. Petitioners reported those sums in 1969 on a capital gain basis.

The Special Master continued his accounting in 1969 and 1970 and issued his report in February, 1970.

Stewart-Warner's motions to vacate the judgment and for reharing *en banc* in the Seventh Circuit were denied on July 8 and September 9, 1969, respectively, and a further petition for certiorari was denied January 12, 1970. In the meantime negotiations resulted in a settlement on March 13, 1970.

After getting the notices of deficiencies for 1969 and 1970 petitioners timely filed an action in the United States Tax Court, which entered its order on October 6, 1976 to the effect that income from American Seating would be ordinary income, and that income from Ever-Level, the direct royalty from Stewart-Warner and the additional royalties in the form of the assigned lost profits due Ever-Level Glides would be afforded capital gain treatment on the basis that all substantial rights of the patent had been transferred. The Tax Court also ruled that income from Robert E. Miller and United Industrial Syndicate was not entitled to capital gain treatment because the court was unable to attribute that income to the Ever-Level license.

Under Rule 155, tax deficiencies of $1,064.73 for 1969 and $4,643.68 were determined. The Commissioner appealed and the petitioners cross-appealed. On February 25, 1980 the United States Court of Appeals, Sixth Circuit, ruled that none of the royalty income was entitled to capital gain treatment on the basis that a dual transfer of all substantial rights to a patent could not qualify under Section 1235 of the Revenue Code of 1954.

The Court of Appeals also found that none of the infringement income could be accured in 1968 on the basis that neither the liability was fixed and the amount of damages could not be readily ascertained.-

The Court of Appeals refrained from considering the matter of income from the United Industrial Syndicate on the basis that it was immaterial in face of its decision that capital gain treatment would not be allowed on any of the royalties.

On February 25, 1980 the case was remanded back to the Tax Court for determination of the tax based on the rulings of the Court of Appeals.

REASONS FOR GRANTING THE WRIT

1. *Regarding the two-part transfer of "all substantial rights"*

The Sixth Circuit has extended the statute by inserting, in effect, the words, "and the transfer must be a single event" into Section 1235. To the best knowledge of the petitioners, this is the first instance in which that position has been taken by the Commissioner or by any court including the Sixth Circuit.

The fragmentation of a patent has been recognized by Congress since 1836, and statutory provision for fragmentation was carried over into the 1952 Patent Code as 35 U.S.C. Section 261 which provides that: "The applicant, patentee, or his assigns or legal representatives may... grant and convey an exclusive right . . . to the whole or any specified part of the United States."

Limiting the field of use is not only an established business practice but is grounded on economic necessity and has

repeatedly been sanctioned by the courts, as in *General Talking Pictures Corp. v. Western Electric Co.*, 304 U.S. 175 (1935) and *Armstrong v. Motorola, Inc.*, 374 F.2d 764 (7th Circuit, 1967), cert. denied, 389 U.S. 830 (1967).

The Sixth Circuit quoted only 3 cases to support its position that the transfer must be a single event:

a. *Fawick v. C.I.R.*, 436 F.2d 655 (Sixth Circuit, 1971)

b. *Mros v. Commissioner*, 493 F.2d 813 (9th Circuit, 1974)

c. *Klein v. Commissioner*, 507 F.2d 617 (7th Circuit, 1974)

In none of the cases above were "all substanital rights" transferred for the tax year in question; therefore they are not germane here where all substantial rights admittedly were transferred.

In *Fawick* the rights retained were so substantial that subsequently a large corporation was set up to exploit the untransferred rights. In *Mros* the inventor transferred part of his rights in 1966 and the remaining substantial rights in 1970, but the court was concerned only with royalty income for 1966. In *Klein* the inventor transferred rights for the Eastern part of the United States in 1960 and in 1969 transferred rights for the balance of the United States, but the court was concerned only with the years, 1966, 1967 and 1968.

The Commissioner and the Sixth Circuit, in ruling that a transfer of "all substantial rights" must be a single event have to rely on the fact that the statute uses the singular, "*a* transfer". However, the statute also uses the singular in reference to "*an* undivided interest", and in that regard the Commissioner states, in its brief in *Eickmeyer v. C.I.R.* 580 F.2d 395 (10th Circuit, 1978), "This is not to say, however, that the right of exclusion cannot be transferred to a group of

users. Certainly, if the taxpayer transfers an undivided more than one person is going to hold the right. . ." In *Eickmeyer* the Tenth Circuit did not question the right of the taxpayer to make multiple transfers (in that case, 12) of undivided interests. It is not consistent for the Commissioner and the Tenth Circuit to say that multiple transfers of undivided interests would qualify for capital gain treatments, but that "all substantial rights" can only be transferred in a single event. Such a ruling prejudices one holder as against another.

Senate report 1622 (3 U.S. Cong. and Adm. News, 1954) refers to the Commissioners Mimeograph 6490 (1950-1 CB9) which apparently was considered too harsh. Accordingly Congress liberalized the rules of transfer for patent rights. The spirit of liberalization of the statute is well-expresed in that report, p. 5083, wherein it stated, ". . .It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner of the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones. . ."

In this present case, the Commissioner, the Tax Court and the Sixth Circuit have all agreed that after the second license, all substantial rights of the petitioners were transferred. Petitioners believe that for the Commissioner and the Sixth Circuit to insist that the transfer must be a single event goes against the will of Congress and against the Treasury Regulation itself, which states, ". . . The circumstances of the whole transaction, rather than the particular terminology used in the instrument of transfer, shall be considered in determining whether or not all substantial rights to a patent are transferred in a transaction."

Other courts have allowed multiple transfers of all substantial rights, as indicated by the following partial list of cases:

a. *E.I. Du Pont de Nemours and Co. v. United States,* 432 F.2d 1052. (C.A. 3, 1970) Transfers of rights to two different licensees on two different dates was allowed capital gain treatment under Section 1235.

b. *Bell International Corp. v. United States,* 381 F.2d 1004 (Court of Claims, 1967) The court stated, ". . . a sale is not defeated because the agreement was subject to an existing license previously granted. . ." (1013)

c. *General Aniline and Film Corp. v. Commissioner,* 139 F.2d 759 (C.A. 2, 1944) A sale was held to have taken place notwithstanding that the patent assignment was to be ". . . subject to all prior committments of *** the grantor including certain exclusive obligations to various named corporations. . ." (760)

d. *Rollman v. Commissioner,* 244 F.2d 634 (C.A. 4, 1957) An agreement was found to be a sale notwithstanding athat it apparently was subject to two existing non-exclusive licenses previously granted.

e. *Donald C. MacDonald, et al v. C.I.R.,* 55 T.C. 840 (1970). A series of transfers of various rights in a group of patents was allowed capital gain treatment.

f. *Estate of G.R. Gowdey v. C.I.R.,* 307 F.2d 816 (C.A. 4, 1962) Capital gain treatment was allowed on payments made for granting franchises to 14 licensees for an ice-cream mix.

Petitioners believe that the viewpoint expressed by the court (C.A. Fifth Circuit) (1958) in *Bannister v. United States,* 262 F.2d 175, as follows, applies in this current case: ". . . the District Judge, instead of following the practical construction given by the courts and admonished by the statute, approached and decided the case from an unduly technical and restricted viewpoint. . ." (177)

2. *Treasury Regulation, Section 1.1235-2 is Ambigious*

The regulation contains the phrase, ". . . means all rights (whether or not then held by the grantor). . ." Though the Commissioner and the Sixth Circuit have relied on the regulation to find against the petitioners, neither of them has answered petitioners' pleas for an explanation of the phrase. Does the phrase refer to past rights, present rights or future rights? Petitioners believe the phrase is ambigious and that it should be struck from the regulation, in accord with established authority that where there is ambiguity in a taxing statute, the taxpayer is entitled to the benefit of the doubt. *Gould v. Gould,* 245 U.S. 151 and *Schwab v. Doyle,* 258 U.S. 529. Again, in this case, there is complete agreement that all rights of substantial value, past, present or future, were transferred in the two licenses.

As an example of the ambiguity perceived in the regulation, the Tax Court in this case stated, ". . .We recognize that section 1235 refers to *a* transfer * * * of property consisting of all substantial rights to a patent" and that this language literally supports respondent's position. Furthermore, we recognize that the language of respondent's regulation, which speaks of "all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent * * * are transferred," is also capable of such an interpretation, although in our opinion this is not necessarily the case. . ." (Opinion, p. 20)

Later, in the case of *Kueneman v. Commissioner,* 68 T.C. 609 (1977), the Tax Court stated it was reviewing its position in regard to Section 1235 as a result of conflicting court decisions, but it again raised doubts as to the meaning of the regulation by stating, "In making such statement, we

are not passing upon how the rule is to be applied when there is a series of transfers. For example, in *Blake v. Commissioner* . . . we recently held that the all-substantial-rights test can be satisfied by a final transfer in a sequence of field-of-use transfers; and nothing said herein is meant to question that application of the general rule."

The Commerce Clearing House's 1977 Federal Tax Guide, in referring to the *Kueneman* case above, stated, "In short, the Tax Court's current position raises almost as many questions as it answers."

3. *Treasury Regulation, Section 1.1235-2 is unreasonable.*

The statute does not prohibit a multiple license under the field-of-use restriction, but the Court of Appeals for the Sixth Circuit reads the treasury regulation as prohibiting a multiple license. Under that interpretation the treasury regulation is unreasonable and lies against patent law which allows fragmentation and against recognition by the courts of the frequent necessity of field-of-use licensing, as evidenced by the statute and cases cited under (1) supra.

Under modern day specialization of marketing it is rare indeed that one licensee would be capable of covering the entire United States on almost any product. If an inventor designed a new energy-saving lightbulb, for example, there would be specialized manufacturers and distributors for household use, automotive use, aircraft use, agricultural use, marine use, mining use, commercial use, industrial use, etc. It is unlikely that one manufacturer or one distributor would be in a position to exploit all those markets.

In *Busse v. United States,* 77-2 USTC, the court stated, ". . .it is clear that when it comes to the tax treatment of patent

sales, there is an affirmative public policy to encourage invention through favorable tax provisions."

The treasury regulation here discourages inventors, for if they cannot have capital gain treatment of royalties the peculiar long-time aspect of prosecuting patents and of patent litigation in many cases would diminish gains to near zero. In this present case the record shows that it took 7 years to prosecute the patent and 11 years to litigate the infringement. Total recovery was $182,222. Legal fees were $115,080. The legal expenses, and considerable other expenses for traveling, telephone expenses, reproductions, hotels, etc. incidental to the patent litigation, were occured during the years 1960 through 1970. If the legal expenses and incidental expenses ran about equal for those 11 years, and tax had to be paid, as the Commissioner demands, on the full income of $182,222 in 1970, it is likely that there would be a net loss to the inventor, even with income averaging and loss carry-forward. Therefore, the treasury regulation is unreasonable.

4. *Accrual of $43,304 of royalty in 1968*

The District Court infringement trial ended in a decision favorable to the petitioners in February, 1967. That decision was affirmed by the United States Court of Appeals, Seventh Circuit, in February, 1968. Certiorari was denied in October, 1968. In December, 1968, the infringer's attorney wrote, in an inter-company memo (which was made part of the record of this case), ". . . in the Blake v. Stewart-Warner litigation our liability has been definitely established during the year 1968, in view of the denial by the Supreme Court of the United States of our petition for a writ of certiorari. . ."

On December 5, 1968, another official wrote, in an intercompany memo, ". . . We pursued this litigation to the

Supreme Court where we received an adverse judgment . . . in view of the fact that we have no further avenues of appeal, it seems to me that we should set up on our books a reserve of not less than 5% of the total sales of $735,668. . ."

A reserve in the amount of $43,304 was accordingly established. Petitioners declared the same amount of income on their income tax.

Section 7481 of the Internal Revenue Code for 1954 in referring to fixation of liability in Tax Court cases, states, ". . .The decision of the Tax Court shall become final— 2(B). . Upon the denial of a petition for certiorari, if the decision of the Tax Court has been affirmed or the appeal dismissed by the United States Court of Appeals. . ."

Section 7481 makes no allowances for motions for rehearing or for other legal maneuvers after the denial of certiorari. Petitioners believe that the denial for certiorari in 1968 in the patent infringement case fixed the liability of the infringer in 1968.

The other requirements of Treasury Regulation, Section 1.461-1 (a) (2) which must be satisfied before an accrual can be made is that the amount thereof can be determined with reasonable accuracy. In this regard both the Tax Court and the Court of Appeals erred in ruling that the amount of liability represented by the accrual of $43,304 was not readily ascertainable in 1968. The error arose from failing to distinguish between the royalty directly due the petitioner and the royalty which indirectly flowed to the petitioner representing the amount of lost profit to Ever-Level.

The direct royalty involved only two items — the amount of sales multiplied by a reasonable royalty rate. The Tax Court stated, ". . . the basis for determining the amount of petitioner's recovery . . . was disputed and clearly not reasonably calculable until that report was issued in 1970. . .(footnote appended) The special master described his task as calculating the incalculable."

The Court of Appeals stated, "...It was not until later, in 1970, that the special master, after investigating the contentions of the parties, determined and reported that a reasonable royalty to be paid by Stewart-Warner was seven percent and that the number of infringing glides was 4,716,470..." (The figure of 4,716,470 was a typographical error — it should have been 3,716,470.)

Both courts overlooked the fact that the amount of infringing sales on the direct royalty appeared in Exhibit 22V, which was dated Dec. 28, 1968, (in the record of this case) and was stipulated to in the proceedings before the special master. The special master simply accepted the report.

The determination of what rate of royalty to apply against those known sales was based on the royalty rates set forth in the licensing agreements from which the royalties arose. The reserve set up by Stewart-Warner in 1968 was $43,304. Two years later the special master arrived at a figure of $51,496. To make his determination the special master had to look at only a one page exhibit and two licensing agreements. It took only four and a half pages of his 33 page report for the master to decide on the direct royalties. He read no depositions, had no witnesses, and did not question the principals. The considerable work done by the master (1600 pages of testimony, 700 pages of depositions and 200 exhibits) as reported by him (p. 32 of his report, part of the record herein) was done primarily relative to the difficult question of lost profits to Ever-Level caused by the infringement. No amount was accrued by either Stewart-Warner or the petitioners for those damages.

In the case of Continental Tie & Lumber Co. v. United States, 286 U.S. 290 this Court stated that the problem in that case was "...whether the taxpayer had in is own books and accounts data to which it could apply the calculations required by the statute and ascertain the *quantum* of the award within reasonable limits..." Petitioners had such data

for they used exactly the same figure as the infringer.

It is well established that when there are undisputed facts the higher court stands in substantially as good a person as the lower court; therefore the question of the accrual is reviewable.

5. *If capital gain treatment is allowed, the income from the United Industrial Syndicate should be reviewed"*

The Court of Appeals, having decided against capital gain treatment of any royalty income, did not review the succession of the Level Corporation to the United Industrial Syndicate. If this court allows capital gain treatment of the royalties, that succession should be reviewable.

CONCLUSION

This case exemplifies the classic situation which call for intercession of this Court of Last Resort for the following reasons:

1. Section 1235 itself was devised by Congress to settle controversy and harsh treatment of a treasury regulation, but the controversy and harsh treatment has continued, before and since 1954.
2. The ambiguity of the treasury regulations has caused learned judges to arrive at different interpretations, in different cases and, sometimes on the same case, in dissention.
3. The various circuits of the Courts of Appeal do not agree as to how to read Section 1235.
4. The Court of Appeals for the Sixth Circuit alone says a multiple transfer is not allowed.

5. The Court of Appeals, Sixth Circuit chides the Tax Court in *Kueheman,* supra, by stating, ". . .The Tax court initially got off the track in applying Section 1235 . . . . and has stayed off the track . . . . the Tax Court thereby got one set of wheels back on the track. . ." (p/8, Opinion, Court of Appeals, this case.)

For the foregoing reasons, petitioners pray that a Writ of Certiorari be issued to review the Opinion of the United States Court of Appeals, Sixth Circuit.

Respectfully submitted,

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APPENDIX A

UNITED STATES TAX COURT

DAVID R. BLAKE & BETTY H. BLAKE, Petitioners *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 8235-74. Filed October 6, 1976.

1. Petitioner owned a patent on a leveling device. He granted an exclusive license to America in 1954, limited to the public seating field, and an exclusive license to Ever-Level in 1960, limited to the restaurant field. He received royalties under both licenses as well as damages for patent infringement by others. *Held,* petitioner retained valuable rights at the time of the American license and is not entitled to capital gain treatment of royalties received thereunder under sec. 1235, I.R.C. 1954. *Fawick v. Commissioner,* 436 F.2d 655 (6th Cir. 1971), revg. 52 T.C. 104 (1969), followed under the doctrine of *Jack E. Golsen,* 54 T.C. 742 (1970), affd. on the substantive issue 445 F.2d 985 (10th Cir. 1971). *Held further,* on the facts of this case, the Ever-Level license constituted a transfer by petitioner of all substantial rights to his patent and he is entitled to the benefit of sec. 1235 with respect to royalties and infringement damages attributable thereto. *Fawick v. Commissioner, supra,* distinguished.

2. Petitioner, an accrual basis taxpayer, brought suit against an alleged infringer. The district court held his patent infringed, the court of appeals affirmed, and certiorari was denied in 1968. In 1970, a special master issued a proposed report fixing damages. The

case was settled in that year. *Held,* the amount of damages could not be determined with reasonable accuracy prior to 1970 and was not income prior to that year.

3. *Held,* petitioner is not entitled to a deduction or an addition to cost with respect to the surrender in 1969 of a right to additional royalties.

David R. Blake, pro se.

Thomas R. Ascher, for the respondent.

TANNENWALD, *Judge:* Respondent determined deficiencies of $1,447.20 and $26,177.38 in the petitioners' Federal income taxes for 1969 and 1970, respectively. The issues now presented for decision are:

1. Whether amounts received with respect to certain patent licensing agreements are taxable as long-term capital gain under section 1235[1] or as ordinary income;

2. Whether a portion of damages received in 1970 in settlement of a patent infringement suit should have been accrued as income in 1968;

3. Whether the surrender in 1969 of the right to receive certain royalties gave rise to a deduction or addition to cost in that year.

FINDINGS OF FACT

Some of the facts are stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

[1]All statutory refeences are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years involved.

Petitioners, husband and wife, resided in Detroit, Michigan, at the time their petition was filed. They filed joint Federal income tax returns, amended joint returns, Federal partnership returns of income. and amended partnership returns for the years 1969 and 1970. At all material times, petitioners and their partnership have reported their income on the accrual basis. The events in question relate to the activities of David R. Blake, who will hereinafter be referred to as petitioner.

On July 24, 1948, petitioner applied for a United States patent on a leveling device (hereinafter referred to as a "glide") for tables and chairs. A patent was issued with respect to this application on March 22, 1955. On June 24, 1954, petitioner entered into a "License Agreement" with the American Seating Company (hereinafter "American" or "American Seating"). Under that license, American was entitled to make, have made, use, and sell glides during the life of the patents. The license was limited to the public seating field, i.e., "furniture and equipment for schools, churches, chapels, courtrooms, hospitals, theaters, auditoriums, and vehicles used in transportation" but excluding "furniture designed primarily for restaurant and cafeteria use."[2] It provided for a royalty of eight-tenths of one cent (adjusted annually to reflect fluctuations in the consumer price index) on each glide sold by American. American agreed, among other things, not to compete with petitioner in the sale of glides *per se* (not incorporated in manufactured articles) outside the public seating field. The license could be made nonexclusive or cancelled by

[2]Although the license could be construed to grant American a nonexclusive license in the restaurant field, both parties herein have treated the "public seating" limitation as applying to the entire license rather than only to its exclusive feature.

petitioner if minimum royalties were not paid. It could also be cancelled by either party on the other's default. In the event the patents were infringed by a competitor of American, petitioner undertook to take action against the infringer at his own expense. If he did not do so, American could take action in his name "and for the account of the parties as their interests may appear." American was authorized to withhold royalties during such proceedings and to apply them to defray the cost of a successful action. Petitioner had no liability for costs in excess of royalties.

Effective in November 1954, petitioner granted a ten-year license under the same patent to Ever-Level Glides, Inc. (hereinafter "Ever-Level"). Under their agreement, Ever-Level was to pay royalties of 7 percent of the net selling price of glides it sold. However, the royalty was limited to 5 percent until Mason & Parker Manufacturing Co., an alleged infringer, ceased (voluntarily or through legal action by petitioner) to manufacture or sell devices similar to the glides. The additional 2-percent royalty on sales made in the meantime was to be paid once the stated condition was satisfied. Petitioner did not commence any action against Mason & Parker under this agreement and never received the additional 2-percent royalty.

On April 6, 1960, petitioner and Ever-Level executed a "Patent Royalty Agreement" which superseded the 1954 license. The 1960 agreement gave Ever-Level an exclusive license to make, have made, use, and sell glides throughout the United States and Canada for the life of the patents, subject to the American Seating license. Royalties were set at 5 percent of the net selling price of glides sold by Ever-Level. Should annual royalties with respect to sales in fields outside the "restaurant trade" not reach a specified minimum, the license would become nonexclusive with

respect to those fields. The restaurant trade was defined as sales "for use in establishments offering food and/or drink to the public." There was no minimum royalty on sales in the restaurant field. Ever-Level never paid the minimum royalty on nonrestaurant sales, and its license became nonexclusive as to such sales in 1963.

The 1960 license provisions regarding suits against alleged infringers were similar to those contained in the American Seating license. In addition, petitioner was obligated to defend infringement suits brought against Ever-Level at his own expense. Any net profit resulting from a suit by Ever-Level against an infringer was to be divided equally between it and petitioner.

Petitioner again agreed that he would "commence and vigorously and in good faith prosecute" an infringement action against Mason & Parker. If that action was unsuccessful, royalties would be reduced by half and, if unfavorable on the merits, Ever-Level had the right to cancel. If petitioner did not commence such an action promptly, Ever-Level could pay royalties into escrow pending the outcome of a suit. In the event of a successful action, petitioner would be entitled to the escrowed royalties plus one-half of the royalties which had previously been withheld under the 1954 agreement.

Ever-level could cancel the agreement on 60 days' notice, and petitioner could cancel in the event of default. Both parties' rights were subject to a binding arbitration provision. The agreement would terminate on bankruptcy or similar event affecting Ever-Level. It was binding on both parties and their successors and could be assigned by either with the consent of the other. If petitioner desired to sell his patents, Ever-Level had a right of first refusal.

Petitioner thereafter attempted unsuccessfully to find a

business willing to purchase rights under his patent outside the fields covered by the American Seating and Ever-Level licenses. He was told by those he contacted that it would not be commercially worthwhile to manufacture and sell glides in a market that excluded the public seating and restaurant fields.

Following acrimonious dispute between them, petitioner and Ever-Level cancelled all previous agreements on May 1, 1969 and executed a settlement agreement. This agreement granted Ever-Level a royalty-free nonexclusive license limited to the restaurant field. Petitioner agreed to pay certain legal fees, and a promissory note issued by petitioner to an officer of Ever-Level was cancelled. Ever-Level assigned to petitioner all rights to recover damages for infringement of petitioner's patents.

An infringement action by petitioner against Mason & Parker was begun in 1968 and successfully concluded in 1969. As an inducement for Ever-Level to enter into the May 1, 1969 settlement agreement, petitioner released any claim for the additional 2-percent royalty provided in the 1954 agreement. Ever-Level did not reduce, withhold, or pay into escrow any royalties under the 1960 agreement.

Petitioner and Ever-Level sued Bassick Co. and Stewart-Warner Corporation (hereinafter jointly referred to as "Stewart-Warner")[3] for infringement of the glide patents. On February 23, 1967, the United States District Court for the Northern District of Illinois found the patents infringed. This decision was affirmed by the United States Court of Appeals for the Seventh Circuit on February 28, 1968 and petition for certiorari was denied on October 14, 1968. In December 1968, Stewart-Warner determined that it would

[3]Bassick Co. was later merged into Stewart-Warner.

have to pay petitioner damages of $43,304 ($36,783 in royalties and $6,521 in interest) and accrued that amount as a liability on its books. Stewart-Warner's motions to vacate the judgment and for rehearing *en banc* in the Seventh Circuit were denied on July 8 and September 9, 1969, respectively, and a further petition for certiorari was denied on January 12, 1970. In February 1970, a special master appointed to determine damages issued a proposed report. The report stated that the master had reviewed 2300 pages of testimony and depositions and over 200 exhibits. The master found that Stewart-Warner had sold 3,716,470 infringing glides, of which 3,065,856 were in the field covered by Ever-Level's exclusive license. He found that there was no "established royalty" with respect to the glides but that a "reasonable royalty" would be 7 percent of sales. On that basis, he found that petitioner was entitled to damages of $51,496.76, without interest prior to the filing of the report. He also found Ever-Level was entitled to damages of $131,893 for lost profits. Shortly thereafter, the case was settled by Stewart-Warner's payment of $171,694.88 to petitioner, to whom Ever-Level's claim had been assigned in 1969.

During 1969, petitioner also received, under settlement agreements, infringement damages of $5,527.90 from Robert E. Miller & Co., Inc., and $5,000.00 from United Industrial Syndicate, Inc.

ULTIMATE FINDINGS OF FACT

Upon the grant of the exclusive license to Ever-Level, all substantial rights to petitioner's glide patent had been transferred.

The amount which petitioner was entitled to receive as infringement damages from Stewart-Warner could not be determined with reasonable accuracy prior to 1970.

OPINION

1. Section 1235

The first question we must decide is whether section 1235 entitles petitioner to long-term capital gain treatment of amounts received with respect to his glide patent.[4] Petitioner granted two licenses, one exclusive in the public seating field (the American license) and one exclusive in the restaurant field (the Ever-Level license). He contends that the two licensed fields together covered all significant uses for his invention so that he has made a transfer of all substantial rights therein.

Section 1235 provides for long-term capital gain treatment with respect to "[a] transfer * * * of property consisting of all substantial rights to a patent * * * by any holder."[5] It applies to an exclusive license to make, use, and sell a patented item in all practical fields. See *Fawick v. Commissioner,* 436 F.2d 655 (6th Cir. 1971), revg. on other grounds 52 T.C. 104 (1969). Section 1.1235-2(b)(1), Income Tax Regs., among other things, defines "all substantial rights to a patent" to mean "all rights * * *

[4]Petitioner does not contend that he is entitled to capital gain treatment on any other theory if we find that the requirements of section 1235 are not met. See *Myron C. Poole,* 46 T.C. 392 (1966). But see Rev. Rul. 69-482, 1969-2 C.B. 164.

[5]It is conceded that petitioner was a "holder."

which are of value at the time the rights to the patent * * * are transferred." Thus, petitioner will fail if we determine that, during the taxable years in question, he retained rights which were "of value." Accordingly, it is to this factual question that we initially turn our attention.

At least theoretically, it would appear that petitioner retained some rights after the grant of exclusive licenses to American Seating and Ever-Level since those licenses involved only two fields of use.[6] However, respondent's regulations are addressed to the question of the "value" of those rights and, in that context, the courts have sought, in situations involving field-of-use licenses, to determine whether there was an "established value" (*United States v. Carruthers,* 219 F.2d 21, 25 (9th Cir. 1955); *Flanders v. United States,* 172 F. Supp. 935, 950 (N.D. Cal. 1959)), "potential value" (*Mros v. Commissioner,* 493 F.2d 813, 816 (9th Cir. 1974), revg. T.C. Memo. 1971-123), "known value" (*Fawick v. Commissioner, supra*), "substanial value" (*Gruber v. United States,* 158 F. Supp. 510, 514 (D. Ore. 1958)), "ascertainable fair market value" (*Puschelberg v. United States,* 330 F.2d 56, 61 (6th Cir. 1964)), or "value" (*Bannister v. United States,* 262 F.2d 175, 178 (5th Cir. 1958)). Cf. *E. I. du Pont de Nemours*

[6]The license to Ever-level in respect of the restaurant field became nonexclusive on may 1, 1969. See p. 8, *supra.* But the issue before us involves royalties and damages for infringement arising during the prior periods of exclusivity. In this connection, we note that a substantial portion of the damages for infringement were actually damages to which Ever-Level was entitled from Stewart-Warner. See p. 10, *supra.* Respondent has made no independent argument as to noneligibility of these amounts under section 1235 and the regulations thereunder on the ground that Ever-Level would not be entitled to claim the benefit of that section and that therefore petitioner should also not be so entitled. As a consequence, we do not address ourselves to the potentially knotty problems which may be involved in this aspect of the case.

and Company v. United States, 432 F.2d 1052, 1055 (3rd Cir. 1970), and *Bell Intercontinental Corporation v. United States*, 381 F.2d 10004, 1015 (Ct. Cl. 1967), adopting the standards of "substantial value" and "little tangible value," respectively, in determining whether a transfer of patent rights by a nonholder under section 1235 qualified for capital-gain treatment under sections 1221 and 1222.

We see no reason to engage in a semantic exercise to determine which adjective should be affixed to the word "value" in order to determine whether the aforementioned provision of respondent's regulations has been met. The question to be resolved is one of fact and we are satisfied that petitioner has carried his burden of proof. We base our conclusion on our evaluation of the record as a whole, including the fact that the report of the special master in the infringement action clearly indicates that the only two markets "of any consequence" were the restaurant field and school furniture (public seating).[7] In so concluding, we should point out, however, that petitioner did retain rights of value during the period after the grant of the exclusive license to American Seating for the field of public seating but before the grant of the exclusive license to Ever-Level in the restaurant field; the latter license is clear proof of the

[7]Respondent, at the trial and on brief, objected to the introduction of this report and other documentary evidence on the ground of relevancy. The Court has given careful consideration to respondent's objections and they are hereby overruled. We also note that, in the context of this case, it might have been helpful if the respondent had elected to cross-examine petitioner or offer some countervailing proof that the retained rights had "value," although obviously he was not required to do either. *Potts, Davis & Company v. Commissioner*, 431 F.2d 1222, 1225 (9th Cir. 1970); *Fleischer v. Commissioner*, 403 F.2d 403, 406 (2d Cir. 1968); *John R. Thomas*, 12 T.C.M. 181 (1953).

existence of such value. That period ended well before the taxable years involved herein and therefore we need not concern ourselves with this aspect of the case, except to the extent that the issue of the applicability of section 1235 to field-of-use exclusive licenses is involved — an issue to which we now turn our attention.

Section 1.1235-2(b)(1) of respondent's regulations, in effect during the taxable years involved herein, specifically provides that "[t]he term 'all substantial rights to a patent' does not include a grant of rights to a patent * * * [w]hich grants rights to the grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant." In *William S. Rouverol,* 42 T.C. 186 (1964), we held section 1235 applicable to an exclusive license which contained an industry field-of-use limitation, and in *Thomas L. Fawick,* 52 T.C. 104 (1969), we held the above-quoted regulation (promulgated after *Rouverol* was decided) invalid to the extent it was inconsistent with congressional intent as determined by *Rouverol.* However, our decision in *Fawick* was reversed by the Sixth Circuit Court of Appeals. *Fawick v. Commissioner, supra,* specifically rejected our analysis of the legislative history of section 1235 and held the regulation valid.[8] See also *Mros v. Commissioner, supra; First National Trust & Savings Bank of San Diego v. United States,* 200 F. Supp. 274 (S.D. Cal. 1961).

[8]Cf. *Estate of Klein v. Commissioner,* 507 F.2d 617 (7th Cir. 1974), revg. 61 T.C. 332 (1973), in which this Court had followed our decision in *Vincent B. Rodgers,* 51 T.C. 927 (1969), holding invalid the provision of respondent's regulations denying long-term capital gain treatment under section 1235 to exclusive geographic field-of-use licenses.

In *Fawick*, the issue was whether royalties under an exclusive license containing an industry field-of-use limitation qualified for capital gain treatment under section 1235 where the holder retained valuable rights to other uses at the time of the transaction; at a later date, but before the taxable years involved therein, the taxpayer had assigned his rights in the patent (excluding the rights which were subject to the aforementioned license and certain other rights which he reserved) to a corporation solely in exchange for stock. The Sixth Circuit Court of Appeals resolved the issue in respect of the field-of-use exclusive license against the taxpayer. The *Fawick* decision has since been followed by another circuit court of appeals. See *Mros v. Commissioner, supra.* We find it unnecessary in this case to decide whether we will abandon or continue to adhere to the position we took in *Fawick* and *Mros.* Since an appeal herein will be to the Sixth Circuit Court of Appeals, *Jack E. Golsen,* 54 T.C. 742 (1970), affd. on the substantive issue, 445 F.2d 985 (10th Cir. 1971), requires us to follow the decision of that circuit in *Fawick.* Accordingly, we hold that petitioner is not entitled to the benefits of section 1235 in respect of the royalties from American Seating during the taxable years in question.

A different problem arises with respect to the Ever-Level royalties and the infringement damages awarded to Ever-Level and assigned to petitioner (see footnote 6, *supra*). We have found that, after the grant of the exclusive license to Ever-Level, the petitioner retained no rights of value. In substance, therefore, that license represented a transfer of all of the rights of petitioner other than the rights under the American Seating license. Respondent contends that section 1235 still does not apply to the Ever-Level license on the ground that that section applies only where there is a

single transferee of all substantial rights under a patent. In so contending, respondent points to the second prong of the two-pronged test established by the Sixth Circuit Court of Appeals in *Fawick v. Commissioner,* 436 F.2d at 662:

> If the taxpayer can show that he has no substantial rights in the patent after the transfer, as a second inquiry we must look at what he actually relinquished to the transferee. It is our opinion that the phrase "all substantial rights to a patent" is a reference to the monopoly right for which the patent stands. The monopoly right granted by the patent is the right to exclude others from making, using, or selling the invention. This necessarily encompasses the right to exclude others from any particular industrial field in which those others might choose to use the invention. This is the right that must be sold to the transferee, and the transfer must cover all practical fields-of-use for the invention. [Footnote omitted.]

See also *Mros v. Commissioner,* 493 F.2d at 816; *First National Trust & Savings Bank of San Diego v. United States,* 200 F. Supp. at 282.

Since the only issue before the Sixth Circuit Court of Appeals was the initial field-of-use exclusive license, it is clear that the issue in respect of the second license (Ever-Level) involved herein was not specifically considered in *Fawick* and we therefore do not consider that *Jack E. Golsen, supra,* binds us to follow the Sixth Circuit's analysis in this regard. In fact, we disagree. We see no reason why petitioner should not be entitled to the benefits of section 1235 in respect of the Ever-Level license which we have found constituted a transfer of all rights which were of value to him at the time of the transfer. We recognize that section 1235 refers to "[*a*] transfer * * * of property consisting of all substantial rights to a patent" (emphasis added) and that this language literally supports re-

spondent's position. Furthermore, we recognize that the language of respondent's regulation, which speaks of "all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent * * * are transferred," is also capable of such an interpretation, although in our opinion this is not necessarily the case. See *Bell Intercontinental Corporation v. United States,* 381 F.2d at 1015, n.5. On the other hand, both this Court and the Court of Claims have previously indicated substantial reservations about respondent's position. See *Bell Intercontinental Corporation v. United States,* 381 F.2d at 1013-1015; *Donald C. MacDonald,* 55 T.C. 840, 859 (1971). Moreover, the courts have accorded a liberal interpretation to section 1235. See *Young v. Commissioner,* 269 F.2d 89, 93 (2d Cir. 1959), affirming 29 T.C. 850 (1958); *William S. Rouverol,* 42 T.C. at 1919. Finally, it seems clear to us that a nonholder, who could not claim the benefits of section 1235, could nevertheless report long-term capital gain under sections 1221 and 1222 on such a transfer, and, under these circumstances, we see no reason why section 1235 should be more strictly applied. *Bell Intercontinental Corporation v. United States, supra; Donald C. MacDonald, supra.* We hold that petitioner is entitled to long-term capital gain benefits under section 1235 in respect of the royalties and infringement damages attributable to the Ever-Level license.[9]

[9]See Morreale, "Patents, Know-How and Trademarks: A Tax Overview," 29 Tax Lawyer 553, 560-561 (1976). We do not agree with respondent that our analysis will produce practical problems based on fluctuations between capital gains and ordinary income in the characterization of amounts received pursuant to sequential licensing agreements. We accord capital gain treatment herein only to the license transferring "all substantial rights" then held by petitioner. Under the courts of appeals' decisions in *Fawick* and *Mros,* income from other prior field-of-use exclusive licenses will continue to be taxed as ordinary income, at least with respect to taxpayers in the Sixth and Ninth Circuits.

There are some loose ends. Respondent determined that the infringement damages from Robert E. Miller & Co., Inc. and United Industrial Syndicate, Inc., were ordinary income to petitioner. Since there is nothing in the record to indicate that the infringing sales can be attributed to the Ever-Level license, respondent's position must be sustained. See section 1.1235-1(c), Income Tax Regs. With respect to the damages arising out of Stewart-Warner's infringement, received by petitioner directly, we think at least a portion thereof cannot be attributed to sales in the restaurant field.[10] The special master found that Stewart-Warner sold 3,716,470 infringing glides, of which 3,065,856 (or 82.5 percent) were in that field.[11] The gross amounts awarded by the special master were $51,496.76 to Blake and $131,893.00 to Ever-Level, or an aggregate of $183,389.76. The amount of the settlement determined to be ordinary income in the deficiency notice was $171,694.88. Consequently, we think that only 82.5 percent of 171,694.88/183,389.76ths of $51,496.76 should be taxed as long-term capital gain under section 1235 and the balance of the $51,496.76 should be taxed as ordinary income.

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[10]Amounts received by virtue of the assignment of Ever-Level's claim to petitioner were entirely attributable to such sales.

[11]The special master's report is not clear as to the end-use composition of the remaining 17.5 percent of Ever-level's sales, but it appears highly probable that those sales were for use in the public seating field. Since American Seating was not a party to the infringement suit, there was no need for the special master to make any findings in this regard. To the extent that such damages were attributable to infringing sales in the public-seating field, they would partake of the same taxable character to petitioner herein as the American Seating royalties.

2. Infringement Damages

Petitioner and Ever-Level sued Stewart-Warner and a predecessor corporation for infringement of the glide patents. In 1967, the district court held that there had been an infringement, which holding was affirmed and certiorari denied in 1968. *Blake v. Bassick Co.*, 262 F. Supp. 910 (N.D. Ill. 1967), affd. 392 F.2d 879 (7th Cir. 1968), cert. denied 393 U.S. 828 (1968). Various motions and petitions for certiorari by Stewart-Warner were denied, the last in early 1970 (396 U.S. 1006). Also in 1970, the special master issued his report as to the amount of damages to be awarded and the parties agreed to settle the matter shortly thereafter. Stewart-Warner accrued an amount on its books in 1968 as damages payable to petitioner. Petitioner contends that, following the initial denial of certiorari in 1968, at least the amount so accrued was properly income to him under the accural method of accounting. Petitioner's tax liability for 1968 is not before us.

There are two factual conditions precedent to accrual of an item of income. It must appear that all events fixing the right to receive income have occurred and that the amount of income can be determined with reasonable accuracy. *Ralph L. Brutsche,* 65 T.C. 1034, 1060 (1976); section 1.451-1(a), Income Tax Regs.

We see no need to dwell upon the question whether we should ignore, as petitioner would have us do, the various attempts by Stewart-Warner, after 1968, to reopen the issue of the validity of the patent upon which petitioner's *right* to recover depended. Even if we assume that such right became fixed upon the initial denial of certiorari in 1968, petitioner cannot prevail. It is apparent from the

special master's report that the basis for determining the amount of petitioner's recovery (and that of Ever-Level as well) was disputed and clearly not reasonably calculable until that report was issued in 1970.[12] Under these circumstances, any accrual prior to that year would not be proper. *First Bancredit Corporation v. Flexlume Corporation,* 10 F. Supp. 1015 (W.D.N.Y. 1934). Cf. *United States v. Safety Car Heating & Lighting Co.,* 297 U.S. 88 (1936); *Triplex Safety Glass Co. v. Latchum,* 44 F. Supp. 436 (D. Del. 1942), affd. per curiam 131 F.2d 1023 (3d Cir. 1942); *W. W. Sly Manufacturing Company,* 24 B.T.A. 65 (1931). The cases relied upon by petitioner either are distinguishable or support respondent's position. In *Continental Tie & Lumber Co. v. United States,* 286 U.S. 290 (1932), the Supreme Court held that the amount could have been determined with reasonable accuracy during the taxable year in question. In *H. Liebes & Company v. Commissioner,* 90 F.2d 932 (9th Cir. 1937), affg. 34 B.T.A. 677 (1936), the court of appeals merely held that the amount was not properly accruable in earlier years when the judgment fixing both the right and the amount was fixed but in the taxable year in question when the right of appeal expired or payment was received. In *Lark Sales Company v. Commissioner,* 437 F.2d 1067 (7th Cir. 1970), affg. in part and revg. in part *Richard L. Medd,* T.C. Memo. 1968-244, the court of appeals applied the usual test and went on to hold that the right in question was subject to a bona fide dispute. In *Boston Elevated Railway Co.,* 16 T.C. 1084 (1951), affd. on other grounds 196 F.2d 923 (1st Cir. 1952), this Court held that accrual should be deferred where, although the

[12]The special master described his task as calculating the incalculable.

right of receipt was fixed, the amount and the method of computation thereof were being contested. Finally, in *Lucas v. American Code Co.*, 280 U.S. 445 (1930), although the Supreme Court adverted to the fact that a part of the amount in question had been accrued on the corporate books, it held that this represented no more than what a prudent businessman would do with respect to a *potential* liability and did not justify accrual for tax purposes as long as liability was being contested and the amount of damages was unpredictable; the Court's analysis disposes of petitioner's contention to the extent that it is based on the fact that Stewart-Warner entered an accrual in favor of petitioner on its books in 1968.

3. Surrender of Royalty Rights

In connection with the 1969 settlement agreement with Ever-Level, petitioner abandoned any claim for royalties under the 1954 license agreement which were unpaid due to his failure to bring suit against Mason & Parker Manufacturing Co. Petitioner alleges that such royalties — totaling $6,836.78 — were properly accrued and reported on his tax returns while the 1954 agreement was in force[13] and that he is entitled to an offsetting deduction in 1969 to reflect surrender of his claim to them. Petitioner has wholly failed to establish any legal or factual basis for the asserted deduction.

Initially, we observe that petitioner's attempt to shift the burden of proof on this issue to respondent is unavailing. While the matter may have been raised orally before the

[13]Petitioner testified that he actually reported 50 percent of paid and unpaid royalties because of his belief that they were taxable as capital gains.

Service during the administrative process, that fact has no more effect on the burden of proof than if it had been raised in his original return. Petitioner first formally raised his present contention in an amended partnership return filed after the notice of deficiency was issued and renewed it in his petition. There are no circumstances which would justify our disregarding the general rule placing the burden of proof on petitioner. Rule 142, Tax Court Rules of Practice and Procedure.

The record does not support the contention that the additional royalties in question were properly accruable at any time prior to 1969. Their payment was wholly contingent on success in infringement litigation against Mason & Parker, which success did not occur until that year. Thus, any deduction which might be allowable as a result of other events occurring in 1969 could do no more than offset an equivalent, currently accruable income item. Further, petitioner had already surrendered his right to half the amounts under consideration in the 1960 Ever-Level agreement. Finally, he has not proved that he suffered any loss by relinquishing the balance of his claim. Numerous elements of consideration passed between petitioner and Ever-Level by virtue of the 1969 settlement, only one of which was the assignment to petitioner of Ever-Level's claim against Stewart-Warner. That claim had a value far in excess of the allegedly cancelled royalties, as subsequent events demonstrated.

Petitioner's alternative position, that the amount forgiven should be treated as a cost of acquiring Ever-Level's claim and set off against the recovery received in 1970, must also be rejected. He has not shown any method by which the various items of consideration passing to Ever-Level in connection with the 1969 settlement could be allocated

among the benefits he received. Those benefits included the cancellation of personal indebtedness and the termination of Ever-Level's exclusive license. It is impossible for us to determine what portion, if any, of the cancelled royalties should be treated as a cost properly applied against the 1970 recovery. Cf. *Battle Creek Food Co. v. Commissioner,* 181 F.2d 537 (6th Cir. 1950), affg. 8 T.C.M. 207 (1949). We hold for respondent on this ground as well.

Decision will be entered under Rule 155.

Reviewed by the Court.

QUEALY, *J.*, dissents.

HALL, *J.* concurring: Courts of Appeals in three circuits have rejected our non-literal reading of the statutory term "all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights * * *." *Estate of Klein v. Commissioner,* 507 F.2d 617 (7th Cir. 1974), cert. denied, 421 U.S. 991 (1975), revg. 61 T.C. 332 (1973); *Mros v. Commissioner,* 493 F.2d 813 (9th Cir. 1974), revg. a Memorandum Opinion of this Court; *Fawick v. Commissioner,* 436 F.2d 655 (6th Cir. 1971), revg. 52 T.C. 104 (1969). Respondent's regulations rejecting our position have already been thrice upheld. It is not fair to respondent to continue to force him to litigate this issue. We should now confess error, the more so because none of our opinions on this issue have come to grips with the plain language of the statute. *William S. Rouverol,* 42 T.C. 186 (1964), simply failed to deal with the fact that the language of section 1235 imposed as a precondition for the

statutory safe harbor a more stringent test: "all substantial rights to the patent, or an undivided interest therein which includes a part of all such rights." Words could not be chosen more precisely to preclude the availability of section 1235 to the transfer of a non-undivided interest in a patent with the retention of substantial rights, but *Rouverol* did not focus on the statutory language at all. Nor did our cases following it. *Vincent B. Rodgers,* 51 T.C. 927 (1969); *Thomas L. Fawick,* 52 T.C. 104 (1969), revd. 436 F.2d 655 (6th Cir. 1971); *Estate of George T. Klein,* 61 T.C. 332 (1973), revd. 507 F.2d 617 (7th Cir. 1974), cert. denied, 421 U.S. 991 (1975). We were in error and having now been so instructed by three Courts of Appeal, we should reverse our position and uphold respondent's regulations. Nor are respondent's regulations even particularly harsh. Under them, a patent holder who cannot meet the statutory test may still have recourse to capital gain treatment outside section 1235 if he can meet the holding period required and if he holds the patent as a capital asset. See section 1.1235-1(b), Income Tax Regs. But see *Myron C. Poole,* 46 T.C. 392 (1966).

A further reason for disagreement with the majority is its use of *Jack E. Golsen,* 54 T.C. 742 (1970), affd. on the substantive issue, 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971), to avoid stating our views on the issue. In *Golsen* we said (54 T.C. at 757):

> * * * Moreover, the practice we are adopting does not jeopardize the Federal interest in uniform application of the internal revenue laws which we emphasized in *Lawrence.* We shall remain able to foster uniformity by giving effect to our own views in cases appealable to courts whose views have not yet been expressed, and,

even where the relevant Court of Appeals has already made its views known, by explaining why we agree or disagree with the precedent that we feel constrained to follow.

Golsen did not contemplate that we would abandon our position as a national court for tax matters within our jurisdiction. Our opinions are not written merely to decide the case for the litigants before us, but are for the guidance of the public and respondent (within and without the circuits to which appeal lies). Under our former rule in Arthur L. Lawrence, 27 T.C. 713 (1957), revd. *per curiam* on the substantive issue, 258 F.2d 562 (9th Cir. 1958), we necessarily gave the public the benefit of our views, at the occasional cost of necessitating a superfluous appeal. *Golsen* was intended, quite properly, to eliminate the superfluous appeal; we shirk our duty if we seize upon it as an occasion also to omit the statement of our views for the guidance of taxpayers in circuits other than that to which appeal lies. Whether the Court reaffirms or recants its prior position, the public should be informed.

WILBUR, *J.*, concurring in part and dissenting in part: We again face the issue of whether a use-restricted license represents "all substantial rights evidenced by a patent" under section 1235(a)[1] when the holder has retained valuable rights.

The regulations state that geographic and use-restricted licenses do not convey "all substantial rightrs." Sections 1.1235-2(b)(1)(i) and (iii), and 1.1235-2(c), Income Tax Regs. We have held that these provisions of the regulations

[1]All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise specified.

are unreasonable and plainly inconsistent with the statute and, on three different occasions, have been reversed by three different Circuit Courts of Appeals. *Estate of Klein v. Commissioner,* 507 F.2d 617 (7th Cir. 1974), revg. 61 T.C. 332 (1973), cert. den. 421 U.S. 991 (1975);[2] *Mros v. Commissioner,* 493 F.2d 813 (9th Cir. 1974), revg. a Memorandum Opinion of this Court; *Fawick v. Commissioner,* 436 F.2d 655 (6th Cir. 1971), revg. 52 T.C. 104 (1969).

The formidable and well-reasoned authority arrayed against our position requires a thorough reanalysis by the Court. Unless we can state a clearly articulated and compelling rationale for our position, a tenacious adherence to our prior views will serve only to promote further uncertainty.

In fact, a compelling rationale for the Court's position cannot be stated, since a review of the legislative history underlying section 1235 makes it quite clear that we are in error. Section 1235 was added to the Code in 1954. The House version provided capital gains treatment for a sale or exchange of a patent, an application for a patent, or an undivided interest therein, provided that the "seller retains

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[2]In reversing our decision in *Klein* (a case involving a geographically-restricted patent license), the Seventh Circuit made it clear that geographic and use-restricted patents, for purposes of the issue before us, present essentially the same question by citing the Courts of Appeals opinions in *Fawick v. Commissioner,* 436 F.2d 655 (6th Cir. 1971), revg. 52 T.C. 104 (1969) and *Mros v. Commissioner,* 493 F.2d 813 (9th Cir. 1974), revg. a Memorandum Opinion of this Court, for support. *Estate of Klein v. Commissioner,* 507 F.2d 617, 622 (7th Cir. 1974), revg. 61 T.C. 332 (1973), cert. den. 421 U.S. 991 (1975).

no interest whatsoever" in the patent.[3]

The Senate Finance Committee rewrote section 1235 in its present form. The term "no interest whatsoever" in the House bill was deleted in favor of the term "all substantial rights". The change appears to have been intended to simply permit the seller to retain a security interest in the patent, such as a reversion should the purchaser fail to make the payments.[4] That the term clearly did not

[3]As originally approved by the House, section 1235(a) appeared as follows:

> (a) GENERAL.—Gain from the sale or exchange of property consisting of a patent or application therefor, or an undivided interest therein which includes a part of all rights in such patent or application, by any person whose efforts created such property shall be deemed gain from the sale or exchange of a capital asset if and only if—
>
> (1) the seller retains no interest whatsoever in the patent, application, or undivided interest therein so transferred, except to the extent that the purchase price may be related to the productivity, use, or disposition of the property transferred within a period of 5 years from the date of such sale or exchange; and
>
> (2) the entire proceeds of such sale or exchange are received by the seller within a period of 5 years from the date of such sale or exchange. For purposes of this paragraph, any proceeds due and payable within such period which are received thereafter solely by reason of failure of the purchaser (or any successor in interest of such purchaser) to fulfill a contractual obligation shall be deemed to have been received within such period. [H.R. 8300, 83d Cong., 2d Sess. 259 (1954)].

[4]Several persons testified before the Senate Finance Committee that the "no interest whatsoever" language of the House Bill would prevent the retention of such an interest. Hearings on H.R. 8300 before the Senate Committee on Finance, 83d Cong., 2d Sess. 339 (Statement of Tarleau, Chairman of the ABA Section of Taxation), 492 (Statement submitted on behalf of the ABA Section of Taxation), 1235-36 (Statement of William B. Barnes, a professional mechanical engineer), 1866 (Statement by Francis W. Davis, a consulting engineer) (1954).

encompass geographic or use-restricted transfers can be seen by focusing on the term "undivided interest" (in a patent or all substantial rights to a patent) which appears in both the House and Senate bill.

The Senate Finance Committee explained:

> By "undivided interest" a part of each property right represented by the patent (constituting a *fractional share of the whole patent*) is meant (and not, for example, a lesser interest such as a right to income, or a license limited geographically, or a license which *conveys some, but not all, of the claims* or *uses* covered by the patent). * * * [S. Rept. No. 1622, 83d Cong., 2d Sess. 439 (1954)].[5] [Emphasis added].

The Senate Finance Committee thus specifically stated that an "undivided interest" in all substantial rights did not encompass a use-restricted license. If a fractional interest in "all substantial rights" of a patent excludes a use-restricted transfer, then it seems clear that when the transfer is of the *entire* interest in all substantial rights, a use-restricted transfer is similarly excluded. First, Congress in using the term "all substantial rights" in the first sentence of section 1235 clearly used the word with the same meaning, and this meaning is clearly explained in the Senate Committee Report. Secondly, it would be odd (and

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[5]See also H. Rept. No. 1337, 83d Cong., 2d Sess., A279 (1954), and Summary of the New Provisions of the Internal Revenue Code of 1954 (H.R. 8300) as Agreed to by the Conferees, 105 (1955), Staff of the Joint Committee on Internal Revenue Taxation. The latter, a contemporaneous summary, provides:

> The sale of an undivided interest in a patent which includes a part of each property right represented by the patent will also be deemed to give rise to long-term capital gains. On the other hand, a license limited geographically or limited to certain uses of the patent would notbe considered a sale. The inventor could, of course, sell all the rights covered by, say, the United States patent while retaining foreign patents.

again inconsistent) to exclude a use-restricted transfer from a transfer of a portion of all substantial rights if the broader concept of the entire interest in all substantial rights already permitted such a division.[6]

Petitioner's agreement with Ever-Level raises the second issue of whether, once a use-restricted license is given, the holder of the reserved rights may sell them and receive capital gains treatment under section 1235. Clearly he cannot qualify under section 1.1235-2(b)(1), Income Tax Regs., which defines "all substantial rights" as:

> [A]ll rights (*whether or not then held by the grantor*) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred.* * * [Emphasis added].

Nor can petitioner come within the reasoning of the Sixth Circuit, in *Fawick, supra* at 662, that it is not enough for the taxpayer merely to surrender the last vestiges of his rights, but rather that he must surrender to a transferee the entire bundle of monopoly rights evidenced by a patent (or an *undivided* interest in such rights).

The rationale of *Fawick, supra,* and the regulations is consistent with both the statute and its legislative history. Section 1235 permits capital gains treatment upon the sale of "all substantial rights", not, as petitioners would have us read it, upon the sale of all rights still possessed by the holder. Petitioner did not sell "all substantial rights" in the patent to Ever-Level, but only those rights he still retained. It was the clear intent of Congress, as illustrated previously in this dissent, to give capital gains treatment only to outright sales of patents and not to those who chose to

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[6]See also *Estate of Klein v. Commissioner,* 507 F.2d 617, 621 (7th Cir. 1974), revg. 61 T.C. 332 (1973), cert. den. 421 U.S. 991 (1975).

exploit them through piecemeal dismemberment. Finally, there is no basis either in the statute or the legislative history upon which to make a principled distinction between the last sale conveying the holder's remaining rights and previous use-restricted licenses.[7]

[7]It is no answer to say that a non-holder might qualify for capital gains under certain circumstances. We are here concerned with a "holder" and only with section 1235 (se fn. 4 of majority opinion). A professional inventor clearly can look only to section 1235; amateur inventors are similarly restricted since Congress clearly stated there was to be "no distinction" between the two. H. Rept. 1337, 83d Cong., 2d Sess., 82. It is true that someone else may hold similar property in a different capacity not covered by section 1235 and qualify for capital gains on the sale of a patent. But these are not the circumstances we confront. As to the facts before us the regulation is clear and by no stretch of the imagination can we say it is unreasonable and plainly inconsistent with the statute.

Appendix B

UNITED STATES TAX COURT

WASHINGTON

DAVID R. BLAKE & BETTY H. BLAKE,	)	
	)	
Petitioners,	)	
	)	
v.	)	Docket No.
	)	8235-74
	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
	)	
	)	
Respondent.	)	

DECISION

Petitioners and respondent having filed separate computations for entry of decision and memoranda in support of their respective positions, after due consideration, it is

ORDERED and DECIDED: That there are deficiencies in income tax for the taxable years 1969 and 1970 in the amounts of $1,064.73 and $4,643.68, respectively.

/s/ Theodore Tannenwald, Jr.
Judge

Entered: April 21, 1977

APPENDIX C

Nos. 77-1635, 77-1636

UNITED STATES COURT OF APPEALS

FOR THE SIXTH CIRCUIT

DAVID R. BLAKE and BETTY H. BLAKE,

Plaintiff-Appellees and Cross-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Defendant-Appellant and Cross-Appellee.

ON APPEAL from the United States Tax Court.

Decided and Filed February 25, 1980.

Before: MERRITT and BROWN, Circuit Judges; PECK, Senior Circuit Judge.

BROWN, J. The principal issue raised by this appeal is whether the royalties paid by a licensee to the taxpayer-appellee as holder of a patent were long term capital gain to taxpayer under § 1235 of the Internal Revenue Code of 1954 or were ordinary income. The Commissioner of Internal Revenue found that such royalties were ordinary income and determined an income tax deficiency; on a petition to redetermine the deficiency, the Tax Court held (67 T.C. 7 (1976)) that such royalties were long term capital gain and the Commissioner brought this appeal. There is also an issue whether certain infringement damages payable to taxpayer were accruable in 1968 as taxpayer contended with which the Commis-

sioner disagreed; the Tax Court held that they were not accruable in 1968 and taxpayer appealed.

I

The relevant facts as stipulated or as found by the Tax Court (and which are not in dispute) can be rather briefly summarized.

A. Factual background of capital gain issue

Taxpayers are David R. Blake (hereafter referred to as "Taxpayer") and his wife Betty H. Blake, who filed joint returns for the years 1969 and 1970. It was on these returns that taxpayer, the holder of the patent, reflected the royalties received as long term capital gain.

In 1948, taxpayer filed for a patent on a leveling device for tables and chairs (referred to as a "glide") and a patent was issued in 1955. In 1954, taxpayer entered into a license agreement with American Seating Company (American Seating) whereby it was granted the right, for the life of the patent, to make, have made, use and sell glides but only in the public seating field, i.e. furniture and equipment for schools, churches, courtrooms, theatres and hospitals but excluded furniture designed for restaurant and cafeteria use. The royalty to be paid was eight-tenths of a cent on each glide sold.

In 1960, taxpayer entered into an exclusive license agreement with Ever-Level Glides, Inc. (Ever-Level) to make, have made, use and sell glides for the life of the patent, subject, however, to the American Seating license. It is agreed that the only commercially worthwhile use of the patent outside of the public seating field (covered by the American Seating license) is the restaurant field and is agreed that, upon the license to Ever-Level, taxpayer, as holder of the patent, retained no commercially worthwhile rights that could be the subject of further licensing.

Taxpayer reported royalties payable by both American Seating and Ever-Level as long term capital gain. The Commissioner disagreed. The Tax Court held that royalties payable by American Seating were ordinary income, and taxpayer did not appeal this holding. However, as before indicated, the Tax Court held that the royalties payable by Ever-Level were long term capital gain from which holding the Commissioner has appealed. Further, as also indicated, this is the principal issue on this appeal.

B. Factual background of other issues.

Taxpayer and Ever-Level cancelled their license agreement in 1969, and as part of the cancellation agreement Ever-Level transferred to taxpayer all rights to recover damages for infringement in the field covered by Ever-Level's license. Prior thereto, taxpayer and Ever-Level had jointly sued Stewart-Warner Corporation for infringement. In 1967, a federal court had held that the patent had been infringed; and its decision had been affirmed on appeal, certiorari had been denied, and Stewart-Warner had set up a reserve for its liability of $43,304 (royalty and interest) in 1968. However, Stewart-Warner moved to vacate the judgment and moved for a rehearing *en banc*, which were denied in 1969, and a second petition for certiorari was denied on 1970. Later, in 1970, a special master determined, after having reviewed 2,300 pages of testimony and 200 exhibits, that Stewart-Warner had sold 4,716,470 infringing glides of which 3,065,856 were in the field covered by Ever-Level's license. He determined a reasonable royalty rate to be seven percent of sales and that taxpayer was entitled to recover damages of $51,496.76. The master also determined that Ever-Level was entitled to recover $131,893 as lost profits. Taxpayer settled the whole claim against Stewart-Warner for $171,694.88.

Taxpayer, on the accrual basis, contends that he was entitled to accrue in 1968 all or at least some of the amount payable by Stewart-Warner and contends that that part of

the recovery attributable to royalties was long term capital gain. The Commissioner contended otherwise, and the Tax Court held that taxpayer was not entitled to accrue any of this income in 1968 but that the royalty component was long term capital gain. Taxpayer has therefore appealed the holding of the Tax Court that he was not entitled to accrue in 1968, and the Commissioner has appealed the holding that the payment by Stewart-Warner was in part long term capital gain.

Taxpayer also reported infringement damages received from United Industrial Syndicate as long term capital gain, it being his contention that such were in effect royalties for infringement in Ever-Level's field of use. The Commissioner contended otherwise. The Tax Court held that the proof did not support such attribution to Ever-Level's field of use and therefore held this to be ordinary income from which taxpayer appealed.

Since we hold that all royalties payable by Ever-Level were ordinary income, it follows and we hold that, for this reason, no part of the payment made by Stewart-Warner is long term capital gain and that the payment made by United Industrial Syndicate is likewise ordinary income.

II

It is taxpayer's position, succinctly stated, that since he, as the patent holder, in 1960 transferred to Ever-Level all of his *remaining* substantial rights to the patent, this was a transfer to Ever-Level of "property consisting of all substantial rights to a patent" within the meaning of § 1235 of the Code. On the other hand, it is the position of the Commissioner that, since taxpayer had, prior to 1960, transferred substantial rights to the patent to American Seating, taxpayer's transfer to Ever-Level in 1960 was not a transfer of "property consisting of all substantial rights to a patent" within the meaning of § 1235. Taxpayer, therefore, contends that the

royalties received from Ever-Level should be afforded long term capital gain treatment under § 1235 since he transferred to Ever-Level all of the patent rights that he had at the time of the transfer. The Commissioner contends, on the other hand, that this transfer to Ever-Level did not satisfy the requirements of § 1235 because all patent rights in existence at the time of the transfer were not transferred to Ever-Level.

We conclude that, under the reasoning of this court in *Fawick* v. *Commissioner*, 436 F.2d 655 (6th Cir. 1971), the Commissioner was correct and the Tax Court was in error and therefore we reverse the Tax Court. Indeed, the Tax Court, in its opinion, recognized that it was refusing to follow the reasoning of this court in *Fawick*, and it also in effect held to be invalid a Treasury Regulation that had been specifically upheld in *Fawick*.

Section 1235 of the Code provides in relevant part as follows:

> SEC. 1235. SALE OR EXCHANGE OF PATENTS.
>
> (a) *General.* A transfer . . . of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are —
>
> (1) payable periodically over a period generally coterminous with the transferee's use of the patent, or
>
> (2) contingent on the productivity, use, or disposition of the property transferred.

The Treasury Regulation (1954 Code) § 1.1235-2 provides in relevant part:

> § 1.1235-2 *Definition of terms.*
>
> • • •

(b) *All substantial rights to a patent.* (1) The term "all substantial rights to a patent" means all rights (whether or not then held by the grantor) which are of value at the time the rights to the patent (or an undivided interest therein) are transferred. The term "all substantial rights to a patent" does not include a grant of rights to a patent –

(i) Which is limited geographically within the country of issuance;

• • •

(iii) Which grants rights to a grantee, in fields of use within trades or industries, which are less than all the rights covered by the patent, which exist and have value at the time of the grant; or

(iv) Which grants to the grantee less than all the claims or inventions covered by the patent which exist and have value at the time of the grant.

Thus under the plain words of the statute and certainly under the Regulation, the transfer by taxpayer to Ever-Level of his remaining rights to the patent, after having transferred substantial rights to American Seating, simply does not satisfy the test established by § 1235 for long term capital gain treatment.

This court, in *Fawick*, in tracing the history that lead to the enactment of § 1235, pointed out that prior thereto only amateur inventors could obtain capital gain treatment for royalty payments (since otherwise the patent would not be a capital asset in the hands of the inventor) and even an amateur inventor's right to treat his receipt of royalty as capital gain was questioned unless he received it in a lump sum. Thus the purpose in enacting § 1235 was twofold: to allow professional as well as amateur inventors an opportunity to enjoy long term capital gain treatment for their royalties and to allow such treatment even though royalties are payable periodically and even though payment is contingent on the

productivity or use of the patent. Even so, as the *Fawick* court pointed out, long term capital gain treatment of royalties is afforded to the holder of the patent if and only if the transfer of rights in the patent that produces such royalties is a transfer of all existing substantial rights which have commercial value. In this respect the *Fawick* court said:

> With the above cited legislative history as background, it is our opinion that a two prong inquiry is necessary to determine if a transaction qualifies for special treatment under § 1235. The initial inquiry for determining whether or not there has been a transfer by the holder of "property consisting of all substantial rights to a patent" requires consideration of what the holder has left after the transfer. If he retains any substantial rights to the patent, then he has not transferred the property that comprises all those rights.
>
> If the taxpayer can show that he has no substantial rights in the patent after the transfer, as a second inquiry we must look at what he actually relinquished to the transferee. It is our opinion that the phrase "all substantial rights to a patent" is a reference to the monopoly right for which the patent stands. The monopoly right granted by the patent is the right to exclude others from making, using, or selling the invention. This necessarily encompasses the right to exclude others from any particular industrial field in which those others might choose to use the invention.[3] This is the right that must be sold to the transferee, and the transfer must cover all practical fields-of-use for the invention. (Footnote omitted)

Fawick v. *Commissioner of Internal Revenue*, 436 F.2d 655 at 662.

It is true that, in *Fawick*, the precise question presented here was not before the court; the question presented there was the question before the Tax Court in the instant case with respect to the tax treatment of the American Seating royalties.

Nevertheless, as stated, the reasoning of *Fawick* applies here and the Regulation held to be valid in *Fawick* clearly applies here.

The Tax Court initially got off the track in applying § 1235 in *William S. Rouverol,* 42 T.C. 186 (1964) and has stayed off the track* in spite of a series of reversals in: *Fawick* v. *Commissioner,* 52 T.C. 104 (1969), *rev'd,* 436 F.2d 655 (6th Cir. 1971); *Mros* v. *Commissioner,* 1971 P.H.T.C. Memo. No. 71,123, *rev'd,* 493 F.2d 813 (9th Cir. 1974); and *Klein* v. *Commissioner,* 61 T.C. 332 (1973), *rev'd,* 507 F.2d 617 (7th Cir. 1974), *cert. denied,* 421 U.S. 991 (1975). Thus it appears that not only is the holding here required by the holding of this court in *Fawick* but is also consistent with the holdings of other courts of appeal that have dealt with this issue.

III

Since we have held that the royalties payable by Ever-Level to taxpayer were ordinary income, it follows that infringement damages paid by Stewart-Warner and United Industrial Syndicate, even to the extent that they were in the nature of royalties and even if the royalties related to the field of use covered by the Ever-Level license, were ordinary income.

Thus the only remaining question for decision is taxpayer's contention that all or at least part of the infringement damages paid by Stewart-Warner were accruable in 1968 although the special master did not submit his report and a settlement was not reached until 1970.

As we understand taxpayer's contention, which is his strongest position, it is that at least the reserve set up by Stewart-Warner in 1968, after the Supreme Court denied certiorari the first time, in the amount of $43,304 ($36,783 in royalties

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* In its decision in the instant case below holding the royalties payable by American Seating to be ordinary income, the Tax Court thereby got one set of wheels back on the track.

and $6,521 in interest) could and should be accruable by him in that year. The Commissioner contends, on the other hand, that no accrual could take place in that year because all the events fixing the right to receive the income had not occurred and because, in any event, the amount of such income could not be ascertained with reasonable accuracy, relying on such cases as *Gillis* v. *United States,* 402 F.2d 501 (5th Cir. 1968) which so holds.

The record does not show the basis of Stewart-Warner's motion to vacate and for an *en banc* hearing and the second petition for certiorari, and therefore it is difficult if not impossible to make a judgment whether, after denial of the first petition for certiorari, all events fixing the right to receive the income had occurred by 1968. We conclude, as did the Tax Court, that in any event the amount of the income to be accrued could not be ascertained with reasonable accuracy in 1968. It was not until later, in 1970, that the special master, after investigating the contentions of the parties, determined and reported that a reasonable royalty to be paid by Stewart-Warner was seven percent and that the number of infringing glides sold by it was 4,716,470. We therefore affirm the holding of the Tax Court that no part of the infringement damages paid by Stewart-Warner was accruable by taxpayer in 1968.

The judgment is reversed in part and affirmed in part and is remanded for further proceedings consistent with the views herein expressed.

Appendix D

United States Court of Appeals
FOR THE SIXTH CIRCUIT

Nos. 77-1635-6

DAVID R. BLAKE and
BETTY H. BLAKE,

Plaintiff-Appellee
and Cross-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Defendant-Appellant
and Cross-Appellee.

Before: MERRITT and BROWN, Circuit Judges, and PECK, Senior Circuit Judge.

On appeal from a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby reversed in part and affirmed in part and the cause remanded for further proceedings.

Each party to pay own costs on appeal.

ENTERED BY ORDER
OF THE COURT.

/s/ John P. Hehman
Clerk

A TRUE COPY
Attest:
JOHN P. HEHMAN, Clerk
By /s/ Barbara J. Burns
Deputy Clerk

ISSUED AS MANDATE: March 26, 1980
COSTS: NONE

Supreme Court, U.S.
FILED
JUL 22 1980
MICHAEL RODAK, JR., CLERK

No. 79-1876

In the Supreme Court of the United States

OCTOBER TERM, 1979

DAVID R. BLAKE AND BETTY H. BLAKE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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In the Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-1876

DAVID R. BLAKE AND BETTY H. BLAKE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The principal question presented in this federal income tax case is whether royalties received by petitioner[1] pursuant to a patent licensing agreement are taxable as ordinary income, as the decision below held, or are taxable as long-term capital gain under Section 1235 of the Internal Revenue Code of 1954 (26 U.S.C.), as petitioner maintains.

The pertinent facts may be summarized as follows: In 1948, petitioner filed an application for a patent on a leveling device for tables and chairs (referred to as a "glide"), for which a patent was ultimately issued in 1955. In 1954, petitioner entered into a license agreement with

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[1]"Petitioner" refers to David R. Blake. His wife, Betty H. Blake, is a party to these proceedings solely because she filed a joint return with her husband for the years in question.

American Seating Company under which the company was granted the exclusive right to make, have made, use and sell petitioner's patented glide. The license, however, was limited to furniture and equipment in the public seating sphere for schools, churches, theatres, hospitals and the like, but excluded furniture designed for restaurant and cafeteria use. The license agreement provided for a royalty of eight-tenths of one cent on each glide sold by American (Pet. App. 2c).

In 1960, petitioner entered into an exclusive license agreement with Ever-Level Glides, Inc. to make, use, and sell petitioner's patented glide, subject, however, to the American Seating license. Royalties on this license were set at 5% of net sales. The only commercial use for petitioner's glide outside the public seating field (covered by the American Seating license) was the restaurant field acquired by Ever-Level under its licensing agreement with petitioner. Accordingly, upon execution of the Ever-Level license, petitioner retained no significant commerical rights that could be the subject of further licensing (Pet. App. 4a; 2c).

On his returns for 1969 and 1970, petitioner reported the royalties paid under both the American Seating and Ever-Level licenses as long-term capital gain pursuant to Section 1235 of the Internal Revenue Code of 1954. On audit, the Commissioner of Internal Revenue determined that petitioner's piecemeal transfers of his patent rights to American and Ever-Level did not constitute a "transfer * * * of property consisting of all substantial rights to a patent" within the meaning of Section 1235 and that, consequently, the royalties received by petitioner were not eligible for the capital gain treatment provided under that section. In a reviewed decision, the Tax Court unanimously held that the royalties paid by American

Seating were taxable as ordinary income. Petitioner did not appeal from that aspect of the decision. The Tax Court further held, however, that the royalties paid pursuant to the Ever-Level license were taxable as capital gain under Section 1235 (Pet. App. 8a-14a; 3c).

The court of appeals reversed. It held that although the license with Ever-Level accomplished a transfer of all remaining patent rights then possessed by petitioner, it did not effect, as expressly required by Section 1235 and the regulations thereunder, a transfer of all the substantial rights to the patent because petitioner previously had transferred substantial patent rights to American Seating (Pet. App. 4c-8c).

There is a second question in the case involving the accrual of damages recovered by petitioner in a patent infringement suit.

The facts pertinent to this issue are as follows: In 1969, petitioner and Ever-Level cancelled their license agreement. As part of the cancellation agreement, Ever-Level transferred to petitioner all rights to recover damages for infringement in the field covered by Ever-Level's license. Prior to the execution of the cancellation agreement, petitioner and Ever-Level had jointly sued Stewart-Warner Corporation for infringement. In 1967, a federal district court ruled that the patent had been infringed. The following year, the district court's decision was affirmed and this Court denied certiorari. In December 1968, Stewart-Warner established a reserve in the amount of $43,304 (representing royalties and interest) to cover its liability for infringing the patent. Thereafter, however, Stewart-Warner moved in the court of appeals to vacate judgment and for rehearing en banc. The court of appeals denied these motions and this Court denied a second petition for certiorari (Pet. App. 6a-7a; 3c).

In February 1970, a special master determined, after having examined 2,300 pages of testimony and 200 exhibits, that Stewart-Warner had sold 4,716,470 infringing glides of which 3,065,856 were in the field covered by Ever-Level's exclusive license. He concluded that there was no established royalty rate with respect to the glides but that a reasonable royalty would be 7% of sales. Using that rate, the master determined that petitioner was entitled to damages of $51,496.76. The master also determined that Ever-Level was entitled to damages of $131,893 for lost profits. Shortly thereafter, the entire matter was settled by Stewart-Warner's payment of $171,694.88 to petitioner (to whom Ever-Level's claim had been assigned in 1969)[2] (Pet. App. 7a; 3c). On audit, the Commissioner of Internal Revenue determined that the amount Stewart-Warner paid to petitioner in 1970 was taxable to him in that year as ordinary income. In the Tax Court, petitioner claimed that the infringement damages were accruable in 1968 (a year not before the court) because he was an accrual basis taxpayer. The Tax Court unanimously held, however, that the damages were not accruable in 1968, but were includable in petitioners' income for 1970 (Pet. App. 16a-18a). The court of appeals affirmed (Pet. App. 8c-9c).

1. The court of appeals correctly held that petitioner's transfer to Ever-Level of some, but not all, of the substantial rights to his patent did not qualify for capital gain treatment under Section 1235 of the Code. The plain terms of the statute requires that there be "a transfer * * * of property consisting of all substantial rights to a

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[2]During 1969, petitioner also received, under a settlement agreement, infringement damages of $5,000 from United Industrial Syndicate, Inc. (Pet. App. 7a; 4c).

patent." Because petitioner had previously transferred substantial patent rights to American Seating, his subsequent transfer to Ever-Level of the remaining rights to the patent clearly was not a transfer of *all* substantial rights to the patent, as Section 1235 expressly requires.

Petitioner contends (Pet. 9-15) that it is sufficient for purposes of Section 1235 that he transferred to Ever-Level all the substantial rights then possessed by him. But that argument is not only inconsistent with the plain language of the statute, but is directly contrary to the Treasury Regulations promulgated under Section 1235. These regulations (26 C.F.R. 1.1235-2(b)) provide that the term " 'all substantial rights to a patent' means all rights (*whether or not then held by the grantor*) which are of value at the time the rights to the patent * * * are transferred" (emphasis supplied). Thus, as the court of appeals properly concluded, both the statute and the regulations explicitly compel the conclusion that the transfer by petitioner to Ever-Level of his remaining rights to the patent did not qualify for capital gain treatment.

There is, moreover, no basis to petitioner's claim (Pet. 14-15) that the regulations are invalid. As this Court has held on several occasions, Treasury Regulations are presumptively valid and "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501 (1948); see also *Bingler* v. *Johnson*, 394 U.S. 741, 750-751 (1969); *United States* v. *Correll*, 389 U.S. 299, 306-307 (1967). The regulations here are neither unreasonable nor inconsistent with the statute.[3] On the

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[3]Other provisions in the same regulations have been upheld on several occasions. See *Estate of Klein* v. *Commissioner*, 507 F. 2d 617 (7th Cir. 1974), cert. denied, 421 U.S. 991 (1975); *Mros* v. *Commissioner*, 493 F. 2d 813 (9th Cir. 1974); *Fawick* v. *Commissioner*, 436 F. 2d 655 (6th Cir. 1971).

contrary, they merely reaffirm the statutory requirement that there be a transfer of *all* substantial rights to the patent. Furthermore, the regulations are in accord with the legislative history of Section 1235 which indicates that Congress intended that the benefits of that statute would be available only with respect to a transfer that is tantamount to an outright sale of the patent, as opposed to a piecemeal disposition of the patent, such as effected by petitioner here. See *Fawick* v. *Commissioner*, 436 F. 2d 655, 661 (6th Cir. 1971); S. Rep. No. 1622, 83d Cong., 2d Sess. 438-440 (1954).[4]

2. The courts below correctly held that the infringement damages received by petitioner were includable in his 1970 income. The fact that petitioner is an accruable basis taxpayer does not require a contrary conclusion because income is not accruable until all events occur fixing the right to receive income. Here, all events fixing petitioner's right to receive the damage award did not occur until 1970. Moreover, even assuming *arguendo* that Stewart-Warner's liability to petitioner became fixed in 1968, the income still was not accruable in that year because the amount of its liability was not readily ascertainable prior to the time the special master

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[4]The cases cited by petitioner (Pet. 12) do not conflict with the decision below. With the exception of *Rollman* v. *Commissioner*, 244 F. 2d 634 (4th Cir. 1957), none of the cases even involved the application of Section 1235. In *Rollman*, the court held that where the taxpayer-patent holder transferred all rights to his patent to a single corporation, other than the right to grant sub-licenses without his approval, the transfer qualified for capital gain treatment. The court's conclusion there that retention of a veto power over the granting of sub-licenses was not the retention of a substantial right has no bearing on the decision in this case that a transfer of less than all substantial rights to a patent does not qualify for capital gain treatment under Section 1235.

filed his report in 1970. See *United States* v. *Safety Car Heating Co.*, 297 U.S. 88 (1936); *Gillis* v. *United States*, 402 F. 2d 501 (5th Cir. 1968); *Triplex Safety Glass Co.* v. *Latchum*, 44 F. Supp. 436 (D. Del.), aff'd per curiam, 131 F. 2d 1023 (3d Cir. 1942).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

JULY 1980

DOJ-1980-07

Supreme Court, U.S.
FILED
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No. 79-1876

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

DAVID R. BLAKE and BETTY H. BLAKE,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS SIXTH CIRCUIT

REPLY BY PETITIONERS

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Petitioners hereby reply to the Memorandum for the Respondent in Opposition as follows:

1. The cases of *Fawick v. C.I.R.*, 436 F.2d 655, *Mros v. Comm.*, 493 F.2d 813 and *Klein v. Comm.*, 507 F.2d, 617, cited by the respondent to argue that a transfer of patent rights must be a single event to qualify for capital gain treatment are not applicable because in none of them were all substantial rights to the patent transferred. These three cases were cited by the Court of Appeals, and petitioners original petition for a writ here gave details on each of these cases and why they were not applicable. Respondent has again cited the same cases but did not respond to questions about the cases raised in the original petition. In this case all substantial rights admittedly were transferred, making this case distinguishable from the above three cases.

2. The respondent has failed to show where a careful reading of Section 1235, of Treasury Regulation 1.1235-2 or of the Senate Report #1622 (3 U.S. Cong. and Adm. News, 1954, 5082-3) anywhere prohibits a multiple transfer of rights.

Respondent's memo asserts, ". . .the regulations are in accord with the legislative history of Section 1235 which indicates that Congress intended that the benefits of that statute would be available only with respect to a transfer that is tantamount to an outright sale of the patent, as opposed to a piecemeal disposition of the patent, such as effected by the petitioner here. . ."

Petitioners do not believe that the Senate report 1622 (supra) states anything more than that "all substantial rights" must be transferred. Therefore, petitioners, although recognizing the rules of this court as to brevity of a reply have copied all relevant portions of that Senate Report as Appendix A.

While the Senate report mentions that a "lesser interest such as a right to income, or a license limited geographically,

or a license which conveys some, but not all of the claims or uses covered by the patent" would not qualify for capital gains treatment, it does not bar a multiple transfer as long as all substantial rights are transferred.

If an inventor retains some geographical rights, or other rights which have real value then naturally he has not transferred "all substantial rights", but nothing in the statute or in the Senate report prohibits multiple transfers and the several cases cited in the original petition bear that out.

Respondent's memo states that a "piecemeal disposition" of the patent is not allowable, yet the statute specifically provides for the sale of undivided interests and in *Eickmeyer v. C.I.R.*, 580 F.2d 395 (C. of A., 3rd Cir., 1970) the respondent and the court allowed multiple transfers to 12 different persons on different dates, which is certainly a piecemeal disposition.

Nor does Treasury Regulation 1.1235-2 prohibit a multiple transfer. While it is true that in the statute, in the Senate report and in the Treasury Regulation only the singular form is used in referring to "a transfer", the same singular form is used throughout the revenue code in cases where a plurality is accepted without question. For example, most capital gains questions arise from Section 1222 which reads, "The term 'long-term capital gains' means gain from the sale or exchange of *a* capital asset. . ." Under the narrow interpretation of the respondent as applied to this case, a farmer could not sell off a 160 acre farm in four 40 acre parcels and have the benefit of capital gain treatment, a widow could not sell a portion of a wholly owned business she inherited and get capital gain treatment and a home-owner could not sell a contiguous vacant lot separately from his house and get capital gain treatment, because, in each case, "all substantial rights" to "a" capital asset were not conveyed in a single transaction.

Similarly, an inventor of a new energy-saving engine could

not sell automative rights to the Ford Motor Co. and the aircraft rights to the Lockheed Aircraft Company, even at the same meeting, and get capital gain treatment, because once having signed with Ford he then would not have "all substantial rights" to convey to Lockheed.

Further, the statute specifies the singular form in referring to "*an* undivided interest" but the respondent translates that to mean that any number of undivided interests can be sold, as in *Eichmeyer,* supra.

Also, the words, "field of use" do not appear in the Senate Report #1622 or Section 1235 — they appear only in the Treasury Regulation 1.1235-2, purely words of the Commissioner alone.

Though both the Senate Report and the Treasury Regulation, supra, state that substance and not form will control whether or not a transfer of all substantial rights has been made, and while fragmentation of patents, both geographically and by field-of-use has been recognized by Congress (35 U.S.C., Sec. 261) and by the courts, *Armstrong v. Motorola,* 374 F.2d 764 (7th Cir., 1967) the respondent continues in this case to extend the statute by, in effect, putting in the words, "and the transfer must be a single event". Petitioners believe that such a restrictive interpretation lies against the spirit and mandate of the will of Congress as expressed in Senate Report 1622 and the statute, Sec. 1235.

The respondent now says that the case of *duPont v. U.S.* (432 F.2d, 3rd Cir. 1970) did not involve Sec. 1235 and therefore is not applicable, but in his brief to the Tax Court (p. 43, part of the record) the respondent cited *duPont* and stated, "The test to be applied in these circumstances in determining whether in fact there was a sale of the patents is essentially the same test applied in determining whether a

transaction is a sale for purposes of Code Sec. 1235. . ."

The term "all substantial rights" arises in Section 1235. That term or its equivalent is quoted 9 times by the court in *duPont,* supra, thereby supporting petitioner's argument of relevancy of the *duPont* case as to the matter of a multiple transfer.

That observation as to Sec. 1235 was affirmed by the Court of Claims in *Bell Intercontinental v. U.S.* (92-62, 1967) wherein the court stated, "The holding in *First National Bank of San Diego* seems inconsistent with the Treasury Regulations under Sec. 1235. . . which section deals with capital gains treatment for individuals holding patents as distinguished from corporations, but is otherwise virtually identical to the sections applicable here. . ."

Petitioner believe the precedent cases cited by them in their petition are apropos though some are for corporations. The dearth of cases brought by individuals is understandable in view of the fact that these cases take a long time to be resolved — this case has been contested for eleven years now (an audit was started on the 1968 tax).

The respondent dismisses petitioners' citation of *Rollman v. Commissioner,* 244 F.2d 634, (4th Cir. 1957) with the statement that ". . . has no bearing on the decision in this case that a transfer of less than all substantial rights to a patent does not qualify for capital gain treatment under Section 1235." However the agreement in contest in *Rollman,* as quoted by the court, stated, (p. 636) ". . . The license herein granted. . . .shall be exclusive with respect to the Rollman Patents, except for the nonexclusive license possessed by the United States Rubber Products, Inc. and Pirelli, Ltd., Rollman and Grunebaum herein agreeing that except for the two non-exclusive licenses above mentioned, no other licenses will be granted with regard to said patents during the

term of this agreement. . ." The court allowed capital gain treatment even though there were two prior license agreements.

3. The Respondent Makes no Effort to Defend Treasury Regulation 1.1235-2.

The respondent carved out a creature, called Treasury Regulation 1.1235-2 in the image of what he conceived the mandate of Congress to be then hides behind his own creation as though it was molded on high and should not be questioned. He makes no effort to justify the design he himself carved. It is not reasonable for the respondent to turn aside all questions as to the propriety of his own creation simply with the statement, "It must be so because it is there." Learned judges have challenged the regulation too, as described on page 13 of the original petition, but still the respondent makes no effort to answer.

While the respondent has made no effort to explain the treasury regulation phrase, "All substantial rights to a patent means all rights (whether or not then held by the grantor) which are of value at the time the rights. . . are transferred." Petitioners suggest that the probably sources of that phrase are the House Report #1337 (3 U.S. Cong. and Adm. News, 1954) and the Senate Report #1662 (supra) because those two reports have many of the same words. For example the House report reads, ". . . Since the nature of the transaction might not finally be determinable until final receipt by the seller of the proceeds of the sale, the statute of limitations has been modified to permit assessment of any deficiency for any taxable year (*whether or not* before or after the sale). . ."

The Senate report states, ". . . since the inventor possesses an exclusive inchoate right to obtain a patent, *he may transfer his interest, whatever it may be, in any subse-*

quently issued patent before its issuance and before as well as after he has made application for such patent. . ."

Both the House and Senate reports seem to anticipate future events and uncertainties, rather than to prohibit a multiple transfer as the respondent avers. The word "inchoate" means in an initial or early stage and the case at hand fits that pattern exactly, for the first license with American Seating was made before the patent was issued.

Section 1235 of the statute clearly allows capital gain treatment for a transfer of rights even though the payments are "contingent on the productivity, use or disposition of the property transferred," and that such payments may be made "payable periodically over a period generally coterminous with the transferee's use of the patent". Such use could run for the 17 year life of the patent plus whatever period there was between the transfer and the issuance of the patent. In view of the Senate's dictate that ". . . It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not all substantial rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones." and in view of the fact that the code specifically allows variable, conditional payments over a period of 17 years or more, and that a sale can encompass other rights which may later accure to the patent, it is not consistent to hold that a transfer of rights must be in one single event.

Since the code allows for security to the seller, what would be the situation if the seller had to take back the property for default by the buyer? Under the interpretation of the respondent in this case, capital gain treatment would be denied on a resale because rights had previously been conveyed.

Petitioners are aware of the rule that a treasury regulation is presumed valid and that it can be defeated only on a finding that it is unreasonable or inconsistent. However, one perogative of this Court — in fact a duty of this court — is to be a check and balance on an overreaching action of administration. Further, if there is ambiguity in Treasury Regulation 1.1235-2, as the conflicts among the courts indicate, such ambiguity should be held against the commissioner. *Schwab v. Doyle,* 258 U.S. 529.

4. In the matter of accrual of $43,304 of royalty income in 1968, the respondent ignores the fact that liability was fixed in 1968 upon denial of the infringer's petition for certiorari in 1968, according to Sect. 7481 of the Revenue Code for 1954 as stated on page 16 of the original petition.

Further, the respondent has now notified the petitioner that if this petition for certiorari is denied, collection of the tax will be imposed under I.R.C. Sect. 7481, without regard to motions for rehearing or other legal steps. The notice, dated May 5, 1980 is attached as Appendix B. It is unreasonable for the respondent to argue that the denial of certiorari to the infringer did not fix the infringer's liability and then to make a complete about-face and to say that denial of certiorari to the petitioner here will immediately fix the tax liability.

In regard to the ascertainability of the amount of the accrual, the respondent ignores the fact that the damages received by the petitioners were derived from two sources. The first source was direct royalties due from the infringer to the petitioner. That royalty was based on the dollar amount of sales times the royalty rate. The accrual of $43,304 which is the only accrual at issue here is limited to that first source of damages — the direct royalty. For that portion the exact sales were known down to the penny and were stipulated to

for the master in 1968. The fact that the infringer had set up a reserve of $43,304 in 1968 was also known by the master in 1968. The inter-company correspondence of the infringer stating ". . . in the *Blake v. Stewart-Warner* litigation our liability has been definitely established during the year 1968. . ." (detailed on page 15 of the original petition) was known to the petitioners in 1968. To determine the direct royalties the master had only to look at the one-page stipulated exhibit of sales and to the two license agreements to determine the royalty rate. No hearings or witnesses were necessary. The amount of direct royalty actually received in 1970 was $48,212, a reasonable range from the amount accrued of $43,304.

The respondent cites the case of *Gillis v. U.S.*, 402 F.2d 501 (5th Cir., 1968) as holding against accrual. A careful reading of *Gillis,* however, clearly supports petitioners' arguments. In *Gillis* the court allowed the accrual of estimated future sales losses for the sale of cotton and it even allowed the accrual of a disputed claim which was the subject of arbitration. In *Gillis* the court stated, "Items. . . are reported in the year. . . in which the liability . . . becomes fixed and the amount is reasonably ascertainable even though the payment is not then due." (506) Further, "In some cases, all that has been required is that the taxpayer be able to reasonably *estimate* the deduction, and the courts have not required that this estimate be made with 'mathematical precision.' " (507) Also, ". . . all accruals in income taxation need not be calibrated to finite absolutes. . ." (510) "If the government required all taxpayers to estimate accrual expense with such accuracy, very few could use this accounting method." (509)

The second source of damages had to be calculated as lost profits to the other plaintiff in the infringement case, the

Ever-Level Company. It was on that portion that the master spent so much time holding hearings with 1600 pages of testimony, and examining 700 pages of depositions and 200 exhibits. That portion of damages resulted in the master awarding $131,893 in 1970. Neither the infringer or the petitioners made any effort to accrue those damages.

The respondent also cites *United States v. Safety Car Heating Co.,* 297 U.S. 88 (1936). This case concerns itself mostly with the question of whether damages arising from a decree of infringement entered in 1915, for which the master, after 8 year's work, filed a report in 1923 and on which a settlement was paid in 1925 could be proportioned as to damages before and after 1913, the year when the income tax became effective. According to the court, ". . . the respondent made an election . . . to confine itself to the profits received by the infringer. . ." (97) Therefore that case would apply only to the lost profits area here and is not applicable to the accrual claimed for direct royalties.

Similarily, in *Triplex Safety Glass Co. v. Latchum,* 44 F. Supp. 436 (D. Del., 1942) Aff'd 131 F.2d 1023, cited by the respondent, one issue was that the taxpayer accrued income in 1930 from patent litigation prior to the finding of infringement in 1931. Further, the Triplex case also involved lost-profit calculations which were in dispute until 1937 and therefore is not applicable to the accrual of direct royalties in this case.

This is not a case where the trial court must weigh and evaluate testimony from the witness stand. All facts are of record and based on documents. Therefore the reviewing court stands in as good a position as the trial court to make a judgement.

Petitioners believe that the respondent's memo fails to counter the arguments advanced in the original petition in

favor of allowing capital gain on the damages received and the accrual in 1968 of that portion of damages set up as a reserve by the infringer and reasonably ascertainable.

Respectfully Submitted,

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APPENDIX A

SENATE REPORT #1622
(3 U.S. Cong. and Adm. News, 1954)

"Subsection (a) provides that a transfer (other than by gift, inheritance or devise) of property consisting of all substantial rights evidenced by a patent or consisting of an undivided interest therein, by certain holders shall be deemed the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are payable periodically over a period generally coterminous with the transferee's use of the patent or are contingent on the productivity, use, or disposition of the property transferred. The section does not apply to a property right in an invention differing from the monopoly rights evidenced by a patent. However, since the inventor possesses an exclusive inchoate right to obtain a patent, he may transfer his interest, whatever it may be, in any subsequently issued patent before its issuance and before as well as after he has made application for such patent. By "undivided interest" a part of each property right represented by the patent (constituting a fractional share of the whole patent) is meant (and not, for example, a lesser interest such as a right to income, or a license limited geographically, or a license which conveys some, but not all, of the claims or uses covered by the patent). Payments which come within the scope of the section include, but are not limited to, amounts which are payable over a period generally coterminous with the transferee's use of the patent, or amounts which are measured by a fixed percentage of the selling price of the patent article, or are based on units manufactured or sold, or any other method measured by profits, production sale, or use.

Under present law, an express assignment of patent rights by the owner, or an exclusive license of the right to manufacture, use, and sell, the invention thereunder for the life of the patent, can qualify as a "sale or exchange" for tax purposes; thus, the holder can obtain capital-gains treatment on such a transfer if he falls within the "amateur" category. Many court decisions have arrived at this result, not only where the manner of payment has been a lump sum, but also where the purchase price has been conditioned on the use or profitability of the invention, i.e., where it takes the form of "royalty" payments". However, in 1950 the prospect of continued litigation was engendered in this area by the issuance of Mimeograph 6490 (1950-1 CB 9), in which the Commissioner of Internal Revenue announced that he would thereafter regard such assignments or licenses as "providing fo the payment of royalties taxable as ordinary income" if payment is measured by the production, sale, or use of the property transferred or if it is payable periodically over a period generally coterminous with the transferee's use of the patent. To obviate the uncertainty caused by this mimeograph and to provide an incentive to inventors to contribute to the welfare of the Nation, your committee intends, in subsection (a), to give statutory assurance to certain patent holders that the sale of a patent (whether as an "assignment" or "exclusive license") shall not be deemed not to constitute a "sale or exchange" for tax purposes solely on account of the mode of payment.

The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. This requirement recognizes the basic criteria

of a "sale or exchange" under existing law, with the exception noted relating to contingent payments, which exception is justified in the patent area for "holders" as herein defined. To illustrate, exclusive licenses to manufacture, use, and sell for the life of the patent, are considered to be "sales or exchanges" because, in substantive effect, all "right, title, and interest" in the patent property is transferred (irrespective of the location of legal title or other formalities of language contained in the license agreement). Moreover, the courts have recognized that an exclusive license agreement in some instances may const a sale for tax purposes even where the right to "use" the invention has not been conveyed to the licensee, if it is shown that such failure did not represent the retention of a substantial right under the patent by the licensor. It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be examined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones. The word "title" is not employed because the retention of bare legal title in a transaction involving an exclusive license may not represent the retention of a substantial right in the patent property by the transferor. Furthermore, retention by the transferor of rights in the property which are not of the nature of rights evidenced by the patent and which are not inconsistent with the passage of ownership, such as a security interest (e.g., a vendor's lien) or a reservation in the nature of a condition subsequent (e.g., a forfeiture on account of nonperformance) are not to be considered as such a retention as will defeat the applicability of this section. On the other hand, a transfer terminable at will by the transferor would not qualify."

APPENDIX B

OFFICE OF CHIEF COUNSEL

Internal Revenue Service
Washington, DC 20224

CC:TL:Br2
CSTriplett

MAY 5, 1980

Mr. David Blake
11200 Killarney
Onsted, Michigan 49265

Re: Blake v. Commissioner,
(C.A. 6)Nos. 77-1635 & 1636

Dear Mr. Blake:

This confirms your conversation with Mr. Charles Triplett of our office, who informed you that you do not need to file an appeal bond to proceed from your adverse decision in the Sixth Circuit Court of Appeals in your attempt to seek a writ of certiorari in the Supreme Court.

The Tax Court originally determined the amount of your deficiency for 1969 to be $1,064.73, and $4,643.68 for 1970, in its decision entered on April 21, 1977. This was less than the original deficiency proposed by the Commissioner of $1,447.20 for 1969, and $26,177.38 for 1970. Both you and the Commissioner elected to appeal the Tax Court's decision, and the Sixth Circuit, on February 25, 1980,

remanded the case back to the Tax Court for a new decision consistent with the Commissioner's original proposed deficiency.

After the Tax Court decision was originally entered in 1977, you chose not to file an appeal bond as provided in section 7485 of the Internal Revenue Code of 1954, as amended [*I.R.C.*]. For some inexplicable reason, it appears that no assessment was made of the approximately $5,700 originally determined by the Tax Court.

Mr. Triplett discussed this matter with Mr. Boehm of the Detroit Appellate Office of the Internal Revenue Service (tel. no. 266-7720). Mr. Boehm agreed to delay assessment and collection proceedings until your petition for certiorari is resolved by the Supreme Court. If the IRS prevails, then the entire amount of the Commissioner's original deficiency will be assessed when the new Tax Court decision becomes final. *See,I.R.C.* §7481(a).

If you have any further questions, please direct them to Mr. Triplett at 202-566-3470.

Sincerely yours,

N. JEROLD COHEN
Chief Counsel

By: /s/ RICHARD P. MILLOY
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